TAX TREATIES
BETWEEN DEVELOPED
AND DEVELOPING COUNTRIES

Seventh report

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Report of the Group of Experts on Tax Treaties between
Developed and Developing Countries
on the work of its seventh meeting

UNITED NATIONS
New York, 1978
NOT:

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INTRODUCTION

In the 1960s developing countries became aware of the shortcomings of tax agreements whose provisions were patterned after those of bilateral tax treaties concluded among developed countries, in which each party was simultaneously an exporter of capital to and an importer of capital from the other party. Such treaties could not serve as appropriate models when one of the main aims was to encourage the flow of capital in only one direction, i.e., towards the developing countries so as to accelerate their development. For that reason many developing countries did not consider that it was in their interest to conclude such treaties with developed countries.

The United Nations, realizing that treaties that assume absolute reciprocity between unequal partners are not adequate to the needs of the developing countries, has been seeking to formulate fiscal guidelines that would effectively help to increase the flow of resources to these countries. Those efforts originated from Economic and Social Council resolution 1273 (XLIII) of 4 August 1967 which requested the Secretary-General "to set up an ad hoc working group consisting of experts and tax administrators nominated by Governments, but acting in their personal capacity, both from developed and developing countries and adequately representing different regions and tax systems, with the task of exploring, in consultation with interested international agencies, ways and means for facilitating the conclusion of tax treaties between developed and developing countries, including the formulation, as appropriate, of possible guidelines and techniques for use in such tax treaties which would be acceptable to both groups of countries and would fully safeguard their respective revenue interests".

The mandate was subsequently broadened by the Economic and Social Council which in its resolution 1765 (LIV) of 18 May 1973 requested the Group of Experts on Tax Treaties between Developed and Developing Countries, set up by the Secretary-General pursuant to the aforementioned Council resolution, "to continue its work on guidelines for tax treaties between developed and developing countries and to study the implementation of tax agreements, in such areas as income allocation, international tax evasion and avoidance, and tax incentives": In the course of its deliberations the Group has come to the conclusion that it should also address itself to the effect of the double taxation treaties on revenues of developing countries.

The Group of Eminent Persons appointed in 1973, pursuant to Economic and Social Council resolution 1721 (LIII) of 2 July 1972, "to study the role of multinational corporations and their impact on the process of development, especially that of the developing countries, and also their implications for international relations", observed in its report addressed on 22 May 1974 to the Secretary-General and transmitted by the Secretary-General to the Council that "if, through the work of the Group of Experts on Tax Treaties, the provisions of these treaties could be standardized, with only a small number of clauses to be negotiated in particular cases, they would in fact amount to an international agreement on taxation, which we consider to be the final objective". The Group of Eminent Persons recommended "that the bilateral treaties should be as uniform as possible so as to prepare the way for an international tax
The Group of Eminent Persons also recommended "that home and host countries should introduce provisions into bilateral tax treaties for the exchange of available information and should consider the feasibility of an international agreement on the rules concerning transfer pricing for purposes of taxation". 1/

The Group of Experts, basing its work on the OECD Draft Convention of 1963 and the revised text of certain articles published in 1974, was able during its first six meetings to reach a consensus regarding the principle that a country has a primary, but not an exclusive, right to impose a tax at the source, and worked out guidelines for the drafting of provisions relating to business profits, shipping profits, profits from air transport, dividends, interest, royalties and income from independent and dependent personal services. The Group also worked out guidelines for procedural arrangements regarding income and expense allocation, including transfer pricing, between related entities and for the substantive improvement of such allocations. The Group explored the kinds of information that ought to be exchanged and the circumstances and conditions in which the exchange might take place.

The Seventh Meeting of the Group was held at Geneva from 24 October to 4 November 1977 and was attended by the following members: Carlos C. Martinez Molteni (Argentina); Francisco O. M. Dornelles (Brazil); Gilberto Urruta Vistoso (Chile); Pierre Kerlan (France); Thomas Menck (Federal Republic of Germany); A. N. E. Amissah (Ghana); Shri S. Narayan (India); Simcha Gafry (Israel); Mitsuo Sato (Japan); W. H. van den Berge (Netherlands); A. Scheel (Norway); N. M. Qureshi (Pakistan); Efren Plana (Philippines); Hamzah Mergani (Sudan); Max Widmer (Switzerland); Ahmed Zarrouk (Tunisia); Adnan Baser Kafaloglu (Turkey); Maurice Hugh Collins (United Kingdom of Great Britain and Northern Ireland); and Mordecai S. Feinberg (United States of America).

The meeting was attended by observers from the following countries: Austria, Finland, Mexico, Nigeria, the Republic of Korea, Swaziland and Venezuela.

The meeting was also attended by observers from the following international bodies and organizations: the United Nations Conference on Trade and Development (UNCTAD); the United Nations Centre on Transnational Corporations; the International Monetary Fund (IMF); the Organisation for Economic Co-operation and Development (OECD); the International Chamber of Commerce and the International Fiscal Association.

The Group unanimously re-elected the members who had composed the Bureau at its Sixth Meeting, namely: A. N. E. Amissah (Ghana), Chairman; W. H. van den Berge (Netherlands), Vice-Chairman; and A. Scheel (Norway), Rapporteur. K. Kremerv, Chief of the International Tax Section of the Centre for Development Planning, Projections and Policies of the United Nations Secretariat, served as Secretary of the Group and Mr. Holzler, Economic Affairs Officer in the same Section, served as Deputy Secretary of the Group.

1/ The Impact of Multinational Corporations on Development and on International Relations (United Nations publication, Sales No. E.74.II.A.5), chap. XI.
Stanley Surrey of Harvard University (United States of America) served as Special Adviser to the Bureau. Charles Irish of the University of Wisconsin (United States of America) served as Consultant to the United Nations Secretariat.

The Group set up an eight-member Drafting Committee composed of six members of the Group and two members of the United Nations Secretariat to draft the report. The members of the Drafting Committee were the following: Maurice Hugh Collins (United Kingdom of Great Britain and Northern Ireland); Francisco O. N. Dornelles (Brazil); Pierre Kerlan (France); Hamzah Merghani (Sudan); Shri S. Narayan (India); Max Widmer (Switzerland); J. Pierre V. Benoit, Assistant Director of the Centre for Development Planning, Projections and Policies, United Nations Secretariat, in charge of the Financial Resources Development Branch and Michel Battault, United Nations Interregional Adviser on Tax Policy and Administration. Mr. Benoit served as Chairman of the Drafting Committee and Mr. Battault as Secretary.

At the opening of the Seventh Meeting the Group was addressed by the Assistant Director in charge of the Financial Resources Development Branch. He noted that for the first time since its formation the Group was meeting without the presence of Nathan Gordon of the United States of America, who had died suddenly and prematurely on 14 September 1976 while attending the 30th International Congress of the International Fiscal Association in Jerusalem. He then invited the members of the Group to observe a minute of silence in tribute to the memory of Mr. Gordon.

The Assistant Director said that the provisional agenda reflected the Secretariat's hope that during the Seventh Meeting the Group of Experts would be able to complete, even if only in a preliminary form, the formulation of guidelines for bilateral fiscal conventions and would thus be able to devote future meetings to the periodic updating of the guidelines or to the considerations of new topics, including those mentioned by the Group of Eminent Persons. He stressed that the Secretariat was fully aware that because of the constantly changing nature of fiscal concepts and practices the guidelines would inevitably require periodical revision if they were to remain applicable to changing conditions.

The Group adopted the following agenda:

1. Consideration of draft guidelines for taxation:
   (a) Income from immovable property
   (b) Capital gains
   (c) Directors' fees and remuneration of top-level management
   (d) Income earned by artistes and athletes
   (e) Pensions
   (f) Remuneration in respect of government services and social security payments
2. Consideration of draft guidelines:

(a) For non-discriminatory tax treatment of nationals of Contracting States

(b) For taxation of non-permanent residents

3. Consideration of draft guidelines for allocation of income from:

(a) Sale of goods

(b) Use of patent rights

(c) Provision of services

4. The question of the determination of profits and the taxation of royalties in the case of contracts for the provision of equipment and/or services

5. Consideration of draft guidelines for exchange of information for the prevention of recourse to tax havens

6. Formulation of proposals concerning preparatory work for a possible multilateral agreement on the exchange of information concerning direct taxation

7. Practical suggestions concerning the dissemination and application of the guidelines

8. Formulation of proposals concerning preparatory work leading eventually to the conclusion of an international tax agreement as recommended by the 1974 Group of Eminent Persons appointed to Study the Impact of Multinational Corporations on Development and on International Relations

9. Consideration of the feasibility of an international agreement on the rules concerning transfer pricing for purposes of taxation, as recommended by the 1974 Group of Eminent Persons

10. Other matters:

(a) Discussion of recent work done by other organizations in the field of double taxation treaties

(b) Consideration of draft guidelines on personal scope, taxes covered, general definitions, resident diplomatic agents

11. Adoption of the report of the Group on its Seventh Meeting
Chapter I

TAXATION OF INCOME FROM IMMOVABLE PROPERTY, CAPITAL GAINS, DIRECTORS' FEES AND REMUNERATION OF TOP-LEVEL MANAGEMENT, INCOME EARNED BY ARTISTES AND ATHLETES, PENSIONS, REMUNERATION IN RESPECT OF GOVERNMENT SERVICES AND SOCIAL SECURITY PAYMENTS, INCOME EARNED BY STUDENTS AND APPRENTICES AND OTHER INCOME

A. Income from immovable property

In examining this subitem, the Group had before it the following working papers:

"Suggested draft guidelines for tax treaties between developed and developing countries" (ST/SG/AC.8/L.24), section on income from real property; 1/

"Other problems - including income from immovable property, (ST/SG/AC.8/R.36)." 2/

It was recalled that the OECD Model Tax Convention adopted the source principle by granting to the source country the unrestricted right to tax income from immovable property.

Article 6 of that Convention provides as follows:

"1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

"2. The term 'immovable property' shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.

1/ Prepared by Charles Irish of the University of Wisconsin (United States of America) in his capacity as Consultant to the United Nations Secretariat.

2/ Prepared by Carl S. Shoup of Columbia University (United States of America) in his capacity as Consultant to the United Nations Secretariat.
"3. The provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of immovable property.

"4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services."

A question was raised as to whether under article 6 income from immovable property should be taxed on a gross or net basis. It was pointed out that neither the OECD Model Tax Convention nor the proposed guidelines before the Group dealt with that question. A member from a developed country suggested that the question ought to be considered by the Group, especially since the high level of expenses involved in earning income from immovable property made it appropriate to tax such income on a net basis only.

After it had recognized that article 6 did not specify whether the source country should tax on a net or on a gross basis, the Group felt that profits rather than gross income should be taxed. In that respect, although taxation of net income might be an appropriate technique in many cases, there were other cases in which the source country might find it preferable to tax on a gross basis and take the likely expenses indirectly into account in determining the rate of their gross tax. Therefore the Group thought that the question of the technique of taxation should be left to bilateral negotiations between Contracting States.

There was also a question concerning the status of income from ships and aircraft not in normal operation but converted to other uses - such as casinos, restaurants or museums. It was recognized that those terms were used in their customary sense: hence, for example, a ship permanently situated in one place and used as a hotel could be expected to be regarded as a hotel and therefore under some national laws as "immovable property".

The Group agreed that the text of the revised OECD article 6 on income from immovable property was acceptable as a guideline and that that article should be accompanied by the following commentary:

"In keeping with other situations of taxation at the source, the taxation of the income from immovable property should have as its appropriate objective the taxation of profits rather than gross income. Account should therefore be taken of the expenses involved in earning income from real property or from agriculture or forestry. This objective, however, should not preclude the use of a withholding tax on rents from real property, based on gross income; in this case the rate should take into account the fact that expenses were involved in their earning. On the other hand it would be equally satisfactory if where a withholding tax on gross rents is used, the owner of the real property could elect to have the income from the property taxes on a net basis under the regular income tax. This article does not preclude a country which taxes income from agriculture or other immovable property on an estimated or similar basis from utilizing that method."

B. Capital gains

In examining this subitem the Group had before it the following working papers:
"Proposed guidelines for the taxation of capital gains" (ST/SG/AC.8/L.19); 1/

Suggested draft guidelines for tax treaties between developed and developing countries (ST/SG/AC.8/L.24), section on capital gains.

It was recalled that article 13 of the OECD Model Convention granted the source country the right to tax capital gains from the alienation of immovable property and from movable property that is a part of a permanent establishment or pertains to a fixed base for performing independent personal services. It was further recalled that in addition gains from alienation of ships and aircraft may be taxed in the State of the effective management of the relevant enterprise, while all other gains may only be taxed in the State in which the alienator is resident.

Article 13 of that Convention provides as follows:

"1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.

"2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.

"3. Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

"4. Gains from the alienation of any property other than that referred to in paragraphs 1, 2 and 3, shall be taxable only in the Contracting State of which the alienator is a resident."

In document ST/SG/AC.8/L.19 it was suggested that the right of the source country to tax capital gains be broadened to encompass:

"1. Gains from the alienation of shares of the capital stock of a company the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed by that State."

"2. Gains derived by a resident of a Contracting State from the alienation of the capital stock of a corporation which is a resident of the other Contracting State may be taxed in that other State, but only if:

(a) the alienator owns, directly or indirectly, within the 12 month

1/ Contributed by Mordecai S. Feinberg, Associate Director, Office of International Tax Affairs, Office of the Secretary of the Treasury of the United States of America.
period preceding such alienation, stock possessing more than 50 per cent of the voting power of the corporation, and

(b) more than 50 per cent of the fair market value of the corporation's gross business assets are physically located in that other Contracting State on the last day of each of the three taxable years preceding the alienation (or if the corporation has been in existence for less than three years, on the last day of each preceding taxable year of the corporation."

It was pointed out, however, that in the case mentioned under subparagraph 2 above the tax imposed on gains representing reinvested earnings of the corporation whose shares have been alienated should not be higher than the tax imposed on dividends.

In document ST/SG/AC.8/L.24 it was proposed that gains other than those mentioned in the first three paragraphs of article 13 of the OECD Model Convention be assessed and taxed in accordance with the laws in force in either or both of the Contracting States.

With regard to the suggestions contained in document ST/SG/AC.8/L.19, it was generally felt that those suggestions would close widely used tax loopholes. While a few members from the developed countries were of the opinion that the extension of source taxation to gains on sales of shares would not be administratively feasible, other members observed that some countries (both developed and developing) were already taxing such capital gains, sometimes even irrespective of the number of shares transferred.

There was a consensus that gains from the alienation of shares of a corporation whose assets are principally immovable property could be taxed by the State in which the immovable property was situated; however, the taxation by a Contracting State of gains from the alienation by a resident of the other Contracting State of shares of a corporation resident in the taxing State which represent other assets gave rise to divergent views. On the one hand, some members from developed countries argued that such taxation would discourage the flow of foreign investment to developing countries. On the other hand, some members from developing countries argued that there should not be any restrictions on the right of the country in which the company was incorporated to tax capital gains from the alienation of its shares, on the ground that those gains should not be treated differently from dividends. It was also pointed out that such taxation would involve economic effects of multiple taxation of corporate-source income as well as non-neutrality of taxation with respect to the form of doing business.

With regard to the suggestion contained in document ST/SG/AC.8/L.24, the view was expressed that many countries might prefer that the right to tax be governed by domestic laws.

The Group agreed that article 13, paragraphs 1, 2 and 3, of the OECD Draft Model Convention were acceptable but it considered that paragraph 4 should be replaced by the following paragraphs:

"4. Gains from the alienation of shares of the capital stock of a company the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed by that State.
"5. Gains from the alienation of shares other than those mentioned in paragraph 4 representing a substantial participation in a company which is a resident of a State may be taxed by that State.

"6. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, 4 and 5 shall be taxable only in the Contracting State of which the alienator is a resident."

The Group also agreed that paragraphs 4 and 5 should be accompanied by the following commentaries:

"Paragraph 4 is designed to prevent avoidance of taxes on the gains from the sale of immovable property. Since it would often be relatively easy to avoid such gain through incorporation of such property, it is necessary to tax the sale of shares in such a company. This is especially so where ownership of the shares carries the right to occupy the property. To fulfil its purpose the paragraph applies whether the company is a resident of the Contracting State in which the immovable property is situated or is a resident of another State.

"A number of countries considered that a Contracting State should have jurisdiction to tax the gain on the sale of shares of a company resident in that State whether the sale occurs within or outside that State but it was recognized that for administrative reasons the right to tax should be limited to a sale of substantial participation. The determination of what is a substantial participation is left to bilateral negotiations; for example, an agreed percentage of voting power may be used to define the term.

"Some countries may consider that the Contracting State in which the company is resident should tax the alienation of its shares only where a substantial portion of the assets are situated in that State and in bilateral negotiations may urge such a limitation.

"Other countries may prefer that paragraph 5 be omitted entirely.

"Some countries may feel it undesirable to select only the situations in paragraphs 4 and 5 as the additional situations beyond those in paragraphs 1, 2 and 3 for taxation, especially where they consider that tax avoidance situations of special interest to those countries require attention, and therefore instead may prefer to replace paragraph 4 of the OECD Model Convention by the following paragraph:

"'Gains from the alienation of any property other than those mentioned in paragraphs 1, 2 and 3 shall be assessed and taxed in accordance with the laws in force in either or both of the Contracting States.'"

C. Directors' fees and remuneration of top-level management

In examining this subitem the Group had before it a suggested draft guideline contained in document ST/SG/AC.8/L.24. That suggested draft guideline read as follows:
"Directors' fees and similar payments derived by a resident of a Contracting State in his capacity as a member of the Board of Directors of a company that is a resident of the other Contracting State may be taxed in that other Contracting State."

It was pointed out that since the OECD Model Convention gave the source country an unfettered right to tax directors' fees, the suggested draft guideline was in fact the same as article 16 of the OECD Model Convention.

It was recalled that at its first Meeting the Group had briefly touched upon the question of the taxation of directors' fees and that a consensus had emerged concerning the adoption as guideline of the relevant article of the OECD Model Convention.

Some members inquired about the precise concept of a director and the exact nature of his functions. It was observed that it would be worth while reviewing the various legal systems to ascertain more precisely what would be meant by director. It was pointed out that sometimes officials of a company who did not have the formal title of director were entrusted with duties that were in fact those of directors. The concept of director should be extended to officials in the subsidiaries. On the other hand, it was noted that while the concept of a member of the board of directors was clear, one could argue that any employee serving in a managerial capacity could exert an influence on the management of the company. The concept of management of a company beyond or outside the capacity of a director did not lend itself easily to a definition.

The Group was reminded that there were managers living in one country and managing a company in another country. There were even managing companies that managed other companies and received fees for their services. Those companies were not employees of the companies they managed.

It was stressed that article 16 of the OECD Model Convention was restricted to cases of members of the board of directors, who were generally not employees of the company but performed functions for the company for which they received an income. That article, it was observed, included neither hired financial comptrollers nor managing companies that, although performing managerial functions, were not members of the board nor even employees of the company. The Group was then reminded that some countries assumed that a manager was performing his functions at the head office of the company regardless of the manager's residence status. One member from a developed country observed that, except where payments to directors were excessive or represented disguised dividends, it was the practice of his country to treat directors' fees under article 14 or 15 of the OECD Model Convention, as appropriate.

At the end of its discussion of the subitem, the Group felt that the expression "directors' fees" which are understood to include attendance fees (or jetons de présence) should also include payments to persons performing managerial functions. The Group agreed that the text of the guideline for the taxation of directors' fees would include the text of article 16 of the OECD Model Convention which would be completed by the following sentence:

"A similar rule shall apply to officials of a company in top-level managerial positions as to payments received in that capacity from the company."

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The guideline would be accompanied by a commentary which would read as follows:

"The top-level managerial positions of a company resident in a Contracting State may be occupied by persons resident in the other Contracting State. In this situation the principle applicable to taxation by the Contracting State of directors' fees should similarly apply to such top-level managerial officials. The term 'top-level managerial positions' refers to a limited group of positions that involve primary responsibility for the over-all direction of the affairs of the company, apart from the activities of the directors. The term would cover a person who is acting as both a director and a top-level manager."

D. Income earned by artistes and athletes

It was recalled that the matter in this subitem had been discussed at the First and Second Meetings of the Group. Reference was made to the relevant article 17 of the OECD Model Convention, which read as follows:

"1. Notwithstanding the provisions of Articles 14 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as an athlete, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.

"2. Where income in respect of personal activities exercised by an entertainer or an athlete in his capacity as such accrues not to the entertainer or athlete himself but to another person, that income may, notwithstanding the provisions of Articles 7, 14 and 15, be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised."

It was pointed out that paragraph 2 had been added for the specific purpose of curbing the tax avoidance scheme in which an artiste or athlete incorporated himself, so that his remuneration was paid not directly to the performing individual but instead to the corporation which he owned or controlled and of which he was ostensibly a (relatively low-paid) employee. Under that paragraph the corporation receiving the profits would be taxed at source, just as would the artiste or athlete if he had received the remuneration directly.

It was also pointed out that the commentary to article 17 of the OECD Model Convention stated that in cases in which paragraph 2 was inserted in a tax treaty and the exemption method for the relief of double taxation was used by the State of residence of the person receiving the income, then that State would be precluded from taxing such income whether or not the State where the activities were performed exercised its right to tax those profits. Therefore, the commentary suggested that, in order to deal with that problem, the Contracting States might wish either to provide that the credit method should be used or to give the residence country a residual right to tax when the source country could not make use of the primary right to tax conferred on it by paragraph 2.

1/ Tax Treaties between Developed and Developing Countries. First Report (United Nations publication, Sales No. E.69.XVI.2), paras. 79 and 80; and ibid., Second Report (United Nations publication, Sales No. E.71.XVI.2), paras. 57 to 61.
The question was raised as to whether the residence country might, as a political matter, want to retain the same right to use either a credit system or a residual right to tax all remuneration paid directly to artistes and athletes. Without such a provision, the artiste or athlete could negotiate with developing countries to have the remuneration paid directly to him, free of all local taxes. The effect would be that such income would also be exempted from taxation in the residence country where the standard exemption method (provided for in article 23.A of the OECD Model Convention) was used. The proposal to use the credit method or give the residence country the residual right to tax as in the case of paragraph 2 of article 17 would have two desirable results. First, it would ensure that the income would not escape taxation, whether paid directly or indirectly; and, secondly, it would help to eliminate the tax incentive to secure an exemption at source. Of course, if in the source country a steeply progressive tax system were applied, artistes or athletes with high income might seek to have taxes moderated but at least there would no longer exist a tax incentive to secure a complete exemption.

One member from a developed country pointed out that his country found it preferable to tax income paid to artistes and athletes in the same fashion as income from independent or dependent personal services, as appropriate, except that such persons who received large amounts of remuneration could, regardless of the provisions of articles 14 and 15, be subject to tax in the source country. Under that method, an artiste or athlete would be subject to source taxation only if he were present in the source country for a minimum number of days or earned more than a specified amount. The purpose of that method was to exempt from source taxation the artiste or athlete who did not earn a sizable income (such as, for example, a member of an orchestra).

With respect to paragraph 2 of article 17 of the OECD Model Convention, the same member observed that his country accepted the idea of taxing the entertainment corporation or other enterprise as that paragraph proposed, but would limit such taxation to instances in which the earnings of the entertainment enterprise inured to the benefit of the entertainer or athlete actually performing the services. Consequently, that developed country proposed that in bilateral negotiations paragraph 2 be limited so that entertainment enterprises were not taxed at source when it was shown that the payments to the enterprise did not inure directly or indirectly to the artiste or athlete performing the services.

The Group agreed that the text of OECD article 17 was acceptable as a guideline and should be followed by a commentary stating that the term "athlete", though not accompanied by specific elaborations as in the case of the term "entertainer", was nevertheless likewise to be construed in a broad manner consistent with the purpose of the article.

E. Pensions

It was recalled that under article 18 of the OECD Model Convention pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment were taxable only in that State. Although the OECD provision adopted the residence principle for taxation of pensions, it was suggested that the provision might be acceptable to developing countries because in most cases the amount of potential tax revenues was not substantial. It was also suggested that taxation at residence might be a way of eliminating the burden
otherwise imposed on pensioners of complying with foreign tax laws over a relatively insubstantial, but for the persons receiving the pensions oftentimes critical amount. One exception to the general rule of taxation of pensions in the residence countries was proposed, namely, that payments made under the social security legislation of a Contracting State should be taxed only in that State. The specific text thus proposed was taken from the OECD commentary and reads as follows:

"Notwithstanding the provisions of paragraph 1, pensions and other payments made under the social security legislation of a Contracting State shall be taxable only in that State."

It was further pointed out that social security payments often came out of government revenues and were made to secure a minimum standard of living. Therefore, it seemed appropriate that the countries making such payments should have exclusive jurisdiction to tax.

Members from several developing countries objected to taxing pensions exclusively in the residence country. They pointed out that since pensions were in substance a form of deferred compensation for services performed in the source country, they should be taxed at source just as normal employment income would be. They also pointed out that generally the pension payments gave rise to a deduction in the source country. In addition, they mentioned that the flows of pensions between some developed and developing countries were not reciprocal and in some cases represented a relatively substantial net outflow for the developing country. In that respect several members from developing countries indicated that they favoured exclusive taxation of pensions at source. They added, however, that they were willing to grant an exemption from source taxation for amounts equivalent to the personal exemptions allowable in the source country.

Members from developed countries were generally of the view that pensions ought to be taxed only at residence. They suggested that since the amounts involved were not large, developing countries would not suffer measurably from agreeing to residence taxation. Those members also made the point that the residence country was probably in the best position to structure its tax on the basis of the taxpayer's ability to pay.

A question was raised as to how pension payments would be taxed in the case of employees who had performed services consecutively in several different countries - a fairly common practice among employees of transnational corporations. If such employees were taxed in each jurisdiction in which they had previously worked to earn the pension, then each pension payment might be taxed in a number of jurisdictions. It was generally agreed, therefore, that taxation of pensions at source should be practically construed to mean taxation at the place in which the payments had originated, not where the services had been performed.

With respect to payments made under social security schemes of a Contracting State, most members agreed that taxation of those payments would be more appropriately covered under article 19 dealing with government services.

The Group did not reach agreement on OECD article 18 regarding pensions. While members from developed countries supported the article, which gives the right of taxation to the residence country, most members from developing countries suggested amending the article so as to permit taxation of pensions at source. In
such a case an additional paragraph would be added to article 18 and would read as follows:

"However, such pensions may be taxed in the other Contracting State if the payment is made by a resident of that State or a permanent establishment situated therein."

As to "social security" payments, there was general agreement that such payments should usually be taxed by the paying country and that could be accomplished by including those payments in article 19.

The Group felt that the following commentary should accompany the article:

"As to pensions paid by private employers, while the OECD article restricts taxation to the country of residence, most members from developing countries pointed out that in many cases pensions were being paid by enterprises resident in their countries to former employees who had left their countries to reside elsewhere. Those countries consequently felt that the source country should be able to tax such payments. Where such taxation occurred, there could be an allowance of minimum exemption and the like. That view was the basis for the suggested modification of article 18."

There was agreement that in any event taxation of pensions should not be based on the place in which the services had been performed, since that would, for example, involve a difficult task of allocation of a single pension by a head office company among a number of countries in which the pensioner might have worked during his years of employment.

As to "social security" payments, there was general agreement that such payments should be dealt with in article 19 relating to government services rather than in article 18.

F. Remuneration in respect of government services and social security payments

In connexion with this subitem, it was recalled that article 19 of the OECD Model Convention on government service provided, as a general rule, that remuneration paid to an individual by a Contracting State or political subdivision thereof should be taxable only in that State and that the general principle of source taxation applied also in the case of government pensions. Article 19 reads as follows:

"1. (a) Remuneration, other than a pension, paid by a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.

(b) However, such remuneration shall be taxable only in the other Contracting State if the services are rendered in that State and the individual is a resident of that State who:

(i) is a national of that State; or
(ii) did not become a resident of that State solely for the purpose of rendering the services.

2. (a) Any pension paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State,

(b) However, such pension shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that State.

3. The provisions of articles 15, 16 and 18 shall apply to remuneration and pensions in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof."

One member from a developing country explained that his country had included in its tax treaties a provision stating that the right to tax would be allocated to the country of residence, even in the cases where the taxpayer was not its national and came to that country for the very purpose of rendering the services.

The general consensus of the Group was that it was acceptable to follow the OECD Model Convention and to tax earnings and pensions from government service at source. Some members proposed including payments made under social security legislation in that article, and suggested that article 19, paragraph 2, should accordingly be amended as follows:

"2. (a) Any pension shall be taxable only in the State making the payment if:

(i) It is paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority; or

(ii) It is paid out under a public pension scheme which is part of their social security system.

(b) However, such pensions shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that State."

A member from a developed country then explained that the purpose of paragraph 3 of the OECD article on government services was to ensure that employees engaging in business activities on behalf of a State enterprise were taxed on the same basis as other commercial employees. The Group generally agreed that when a Government of one Contracting State engaged in business activities in another Contracting State, the employees engaging in such activities should be taxable in the other Contracting State without regard to their status as employees of the first Contracting State. Therefore, the view of the Group was that paragraph 3 of the OECD article on government services was acceptable. It was recognized, however, that in specific cases distinguishing between business activities and governmental functions might be difficult, for instance in the case of marketing boards and tourist offices, and that tax administrators had in those cases to scrutinize the actual operations of those governmental agencies.
At the end of the consideration of the subitem, most members agreed that the text of article 19 of the OECD Model Convention should be accepted as a guideline with the above-mentioned amendment to paragraph 2 in order to include "social security" payments. The title of the article should be changed accordingly to, for example, "Remuneration in respect of government services and social security payments".

There would be a commentary stating that while there was general acceptance of the article, some developing countries might in bilateral negotiations desire to limit by reference to a ceiling amount the restriction in paragraph 2 (b) on the taxation of pensions by the paying Government where the recipient is a resident-national of another country.

It would also be mentioned in the commentary that some developing countries might prefer that payments dealt with under article 19 should be taxed only by the country of residence.

G. Income earned by students and apprentices

In examining this subitem, the Group had before it suggested draft guidelines contained in document ST/SG/AC.8/L.2h. Those suggested draft guidelines read as follows:

1. A student or business apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned Contracting State solely for the purpose of his education or training shall be exempt from tax in the first-mentioned Contracting State on:

   (a) Payments made to him by persons residing outside that first-mentioned Contracting State for the purposes of his maintenance, education or training; and

   (b) Remuneration from employment in that first-mentioned Contracting State, in an amount not in excess of SDRs for any taxable year.

"2. The benefits of this article shall extend only for such period of time as may be reasonably or customarily required to complete the education or training undertaken, but in no event shall any individual have the benefits of this article for more than five consecutive years."

It was recalled that the OECD Model Double Taxation Convention contained the following provision in its article 20:

"Payments which a student or business apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State."

It was emphasized that the exemption of income earned by students and apprentices was of great importance and that because of their countries' critical
shortage of skills and expertise, some degree of discrimination in favour of students from those countries who sought to acquire technical knowledge abroad would be warranted, should it arise.

One member observed that the question raised under the subitem was twofold. First, it was related to payments received by students from their home countries or abroad; he pointed out that those payments should not be taxed since the source of the payment was not in the country where the student was pursuing his studies. Secondly, the question related to remuneration from employment in the country where the student was a temporary resident.

Concerning that second aspect, members from developed countries generally expressed understanding of the matter. However, one member informed the Group that his country had had for some time exemption for foreign students but that concern had been voiced at the tendency to use the proceeds of the remuneration not for essential consumption but for frivolous expenditures. Another member indicated that if his country accepted the principle of tax discrimination in favour of foreign students, its national students would certainly ask for the same treatment. Other members mentioned that the exemption from taxation of remuneration from employment earned by foreign students might trigger adverse reactions on the part of trade unions or other labour groups. There was a view that a solution would be to grant students a status which would enable them to benefit with respect to their earnings from exemptions granted for minimum incomes. There was also a view that if students elected to stay too long abroad, that would run counter to the developing countries' wish to have their nationals acquire foreign skills and technology as soon as possible.

The question arose whether ceilings should be imposed on the total annual remuneration received by a student and on the number of study years. While certain members favoured such ceilings, others felt that total remuneration or the number of study years would vary with the economic conditions of countries or with the contents of the curricula. The need for a distinction between bona fide students and other students was stressed so that only bona fide students would benefit from tax advantages.

As far as trainees were concerned, it was indicated that if they were to be entitled to tax benefits, there should be a stricter limit on their stay than on the students' - say one to two years.

At the end of its discussion of the subitem, the Group agreed that the text of the guideline for the taxation of income earned by students and apprentices should include the text of article 20 of the OECD Model Convention, which would be supplemented by another paragraph, reading as follows:

"In respect to grants and scholarships not covered by paragraph 1 and remuneration from employment, a student or business apprentice described in paragraph 1 shall be, in addition, entitled during such education or training, to the same exemptions, reliefs or reductions of taxes available to residents of the State which he is visiting."

The guideline would be accompanied by the following commentary:

"Certain members felt that students or business apprentices should be exempted from tax on income received from employment in the Contracting State..."
while they are visiting during their period of study or training. However, it was recognized that this exemption could in some situations be regarded as discriminatory against local students or business apprentices receiving employment income. The limited approach suggested in the added paragraph eliminates the aspect of possible discrimination. Some countries in bilateral negotiations may wish to expand the article by adding a paragraph permitting a further exemption (beyond that generally applicable as a personal exemption or similar allowance under the internal law of the Contracting State) of employment income under certain conditions either by limiting the relevant amount of income or by confining the exemption to amounts required for maintenance and support. In limiting the amount, some countries may wish to utilize as a guide the additional costs incurred as a result of the fact that the students or business apprentices are visitors. If such further exemption is to be permitted it would be appropriate in the case of business apprentices to place a time-limit on the exemption, and also perhaps in the case of students, with a longer period presumably allowed in the latter situation.

H. Other income

In examining this subitem, the Group had before it the suggested draft guidelines for tax treaties between developed and developing countries (ST/SG/AC.8/L.24), section on "Income not expressly mentioned".

It was recalled that article 21 of the OECD Model Convention granted the country of residence the right to tax all income that was not dealt with in any other article, unless such income was connected with a permanent establishment or a fixed base located in the other Contracting State.

Article 21 of that Convention provided as follows:

"1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing articles of this Convention shall be taxable only in that State.

"2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply."

In document ST/SG/AC.8/L.24 it was suggested that taxation of such income should be left to the discretion of each Contracting State.

The suggested draft guideline read as follows:

"Items of income which are not expressly mentioned in the foregoing articles of this Convention shall be assessed and taxed in accordance with the laws in force in either or both of the Contracting States."
One member from a developing country was of the opinion that the source principle of taxation should be recognized as exclusive but other members observed that this would constitute an obstacle to the conclusion of tax treaties between developed and developing countries and therefore endorsed the suggested draft guideline.

While there was general agreement within the Group that the source country should have a right to tax and that this right should be primary, it was pointed out that the proposed text was defective since, on the one hand, it did not exclude the right to tax income from a third State and, on the other hand, it did not create a case where article 23 of the OECD Convention would apply and that therefore it would leave a possibility of double taxation in cases in which the residence country did not either credit the foreign tax against its own or exempt such foreign income.

A member from a developed country suggested therefore that the OECD text should be retained and supplemented by the following addition to paragraph 1:

"except that if such income arises in the other Contracting State, it may also be taxed in that other State".

The Group agreed that the text of article 23 of the OECD Model Convention amended as follows would be acceptable as a guideline:

"1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing articles of this Convention shall be taxable only in that State.

"2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of article 7 or article 14, as the case may be, shall apply.

"3. Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing articles of this Convention, and arising in the other Contracting State may be taxed in that other State."

The Group agreed that the commentary should state:

"Paragraph 3 added to this article permits the country in which the income arises to tax such income if its law so provides. Paragraph 1 also permits taxation in the country of residence. In a situation in which double taxation might otherwise exist, article 23 of the OECD Model Convention would of course be applicable as in other cases of double taxation. In some cases paragraphs 2 and 3 may overlap and in such cases they produce the same result."
Chapter II
NON-DISCRIMINATORY TAX TREATMENT OF NATIONALS OF CONTRACTING STATES

In connexion with the consideration of this item, it was recalled that article 24 of the OECD Model Convention contained provisions prohibiting discrimination on the basis of nationality. Article 24 read as follows:

"1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.

"2. The term 'nationals' means:

(a) All individuals possessing the nationality of a Contracting State;

(b) All legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State.

"3. Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances are or may be subjected.

"4. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

"5. Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.
"6. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

"7. The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description."

A question was raised as to whether paragraph 5 of that article was suitable for inclusion in a tax treaty between developed and developing countries. It was suggested that that paragraph would not be acceptable to those countries that made deductibility of disbursements made abroad by foreign-owned corporations conditional on the recipient being taxed in such countries. After substantial discussion, the feeling of the Group was that the special circumstances mentioned above ought not to be the basis for treaty guidelines of broad application but that in cases where they were likely to create a problem they should be raised in bilateral negotiations.

A member from a developing country proposed that special measures applicable to foreign-owned enterprises should not be construed as constituting prohibited discrimination as long as all foreign-owned enterprises were treated alike; he said that that change represented a notable departure from the general principle of taxing foreign persons on the same basis as nationals but that the problems of tax compliance in cases in which foreign ownership was involved and the politically sensitive position of foreign-owned enterprises in developing countries warranted the change. Therefore, he proposed that paragraph 6 of article 24 of the OECD Model Convention be amended to read as follows:

"6. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which are subjected other similar enterprises the capital of which is wholly or partly owned or controlled, directly or indirectly, by residents of third countries."

He went on to point out that the proposed change in paragraph 6 had been included in several tax treaties to which developed countries were parties. Some members from developed countries pointed out that such a proposal would in fact limit the effect of the non-discrimination article to the prevention of discrimination between enterprises owned by non-residents, thus leaving the door open to discrimination against enterprises owned by non-residents as a class.

Several members from developed countries expressed reservations concerning the proposed change and pointed out that they considered the OECD non-discrimination article as the backbone of the Convention. They recalled that the antecedents of the non-discrimination article in the present OECD Model Convention dated from the nineteenth century. They felt that if such a fundamental principle were to be altered, it would have a significant effect on international tax relations generally. Further, since the proposed change was motivated in part by problems with tax compliance where foreign ownership was involved - essentially, problems with transfer pricing - it was suggested that the problem might be dealt with more properly in other parts of the tax convention, such as in article 9 dealing with associated enterprises.
The Group therefore agreed that the text of article 24 of the OECD Model Convention would be acceptable as a guideline and should be accompanied by the following commentary:

"While recognizing the essential importance of and need for the non-discrimination article, certain countries indicated that in bilateral negotiations they may desire to modify certain paragraphs of that article. Thus, because of difficulties associated with the determination of acceptable transfer payments such as royalties or technical assistance fees, a country may desire to deny deductions for such payments when made by one of its enterprises to a foreign controlling company, whether resident in the other Contracting State or in a third country. As another example, a country which grants tax preferences for certain national objectives may wish to condition the grants on a percentage of local ownership of the enterprise involved. The Group recognized that these special situations should be left to bilateral negotiations."
Chapter III

TAXATION OF NON-PERMANENT RESIDENTS

In considering this subitem the Group had before it a working paper entitled "Taxation of non-permanent residents" (ST/SG/AC.8/L.15). 1/ The paper contained the following remarks:

"Nowadays the staff of enterprises carrying on business are travelling more and more frequently, not only on short-term missions, for example as commercial representatives or for construction or assembly work or surveys, but also for extended stays of several years in a foreign country to work as specialists in a business establishment owned or controlled by their employer.

"Both employees and employers are required to meet their obligations under the different tax legislations applicable to them, namely:

(a) In the case of the employee: the legislation of his State of origin or the State of which he is a national; the legislation of the State in which he works;

(b) In the case of the employer: the rules and restrictions governing payment in the country of work of the employee's remuneration and fringe benefits ...

"A comparison of national laws and administrative practices reveals very far-reaching disparities in the taxation of wages and salaries, not to mention the differences in the amount of taxes due because of the methods and scales of taxation used.

"In the case of expatriate employees, it is found that in some countries they benefit from exceptions to the ordinary law, by virtue of either legislative or administrative action. These privileged systems are justified by the political will to accept foreign technicians and foreign enterprises likely to accelerate the economic development of the country. Likewise, some countries have reduced the tax burdens which normally be borne by their nationals or residents going abroad on behalf of their enterprises or to work in certain countries that are of political or economic importance to the country of origin.

"A number of legislative anomalies are also found, which enable some employees to escape taxation altogether or only to pay taxes much below those imposed on other taxpayers with comparable incomes.

"It is found, moreover, that by dividing their total remuneration between

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1/ Prepared by Mr. Pierre Kerlan, Directeur adjoint, Ministère des finances, Direction générale des impôts, Paris, member of the Group, in his capacity as Consultant to the United Nations Secretariat.
several countries some employees could - in violation of the regulations - also succeed in reducing the actual amount of tax on their income.

"All these disparities give rise to criticism because they create differences, often unjustified, between taxpayers and thus disturb fiscal morality. They impede the management of enterprises because they are factors which upset a rational personnel management policy. Lastly, they create abnormal conditions of competition between neighbouring countries which distort the choice of locations by enterprises and may drive some countries into a tax concession 'auction'. But it must also be recognized that it is becoming more and more common for employees to work outside their country of origin, that this calls for serious study and that harmonized solutions must be found.

"Indeed, it is a striking fact that, for the purpose of determining the profits of enterprises, very elaborate rules have been adopted by most countries in order to enable the enterprises to carry on and expand their activities, without having taxes as a real obstacle: write-offs, subsidies, deduction of all expenses 'required for the production or maintenance of income', such as hospitality, which may also benefit certain employees (e.g., business luncheons), the various advantages allowed to staff members or customers, and so on.

"Similarly, with regard to the taxation of individuals, many legislations provide for very extensive deductions not related to occupational activities (deduction of interest in case of house purchase, life insurance premiums, donations to charity, etc.).

"However, apart from some more or less standard measures, the situation of expatriate employees has not been a subject of particular concern to the legislator. On the contrary, it can be seen that hitherto there has been a very narrow approach to occupational expenses which, moreover, seems more rigid than the approach to other activities (in particular, those of self-employed persons). It thus appears desirable to take account of the additional expenses incurred by employees who are required to work outside their country of origin: dual residence, education of children. Measures to this end would no doubt be more readily accepted than measures intended to achieve a standard reduction of the amount of taxable remuneration. The development of international trade makes the search for an acceptable solution even more urgent."

The discussion focused on the tax problems of foreigners who were temporarily present in the host country for a sufficiently long period of time so that the host country clearly had a jurisdictional base for imposing its tax. The question before the Group was not whether or not the host country should have the power to tax, since it was generally agreed it did have the power, where non-permanent residents were involved, to tax them on their world-wide earned and non-earned income. Instead, the problem was to try to develop some generalization as to how this power ought to be exercised.

The question was raised whether a precedent for the granting of tax advantages could be found in the treatment given to the diplomatic corps, whose members are not taxed by the country of assignment and are assessed in their home country on their salaries only and not on such benefits in cash or kind as the provision of
housing or housing allowances, education grants and hospitality fees. In that connexion, it was pointed out that diplomatic privileges were reciprocal, while no such reciprocity existed in the case of foreign experts working in a host country.

Members from developed countries recognized that it was legitimate for a host country to question the rationale for providing preferential tax treatment to non-permanent residents and thereby treating them as an elite group for tax purposes. However, they pointed out that the question arose whether a potential host country would succeed in attracting the experts or technicians required within the context of its development efforts. Experience had proved that in a climate of strong international competition for technical expertise it was not likely that top-level specialists could be induced to accept temporary assignments abroad unless incentives deemed satisfactory to them were provided. Fear was expressed that without such incentives only second- or third-rate foreign technicians would accept employment offers in developing countries.

It was emphasized that non-permanent residents faced special problems that should be taken into account in taxing them in the host country, for they usually had extraordinary expenses connected with their move to the host country. Once there, they might wish to rent accommodation comparable to that which they were accustomed to in their home country, feel a need for special education for their dependants, desire to maintain regular contacts with their home country through regular visits and deem it desirable to continue their pension, annuity and insurance arrangements in their home country.

Those special problems arose whether the host country was developed or developing. However, where a taxpayer from a developed country took up temporary residence in a developing country there were often such additional factors as difference in social amenities and price structure which would be reflected in the non-permanent resident's salary which would therefore be subject to the higher brackets of the host country's progressive income tax.

The issue was therefore one that depended on pragmatic considerations. Was there an urgent need in a given developing country for a foreign expert? Were the socio-economic conditions - including the prospect of quick financial rewards - such that foreign experts would be attracted to that particular country without special inducement and if not, what incentives would the country be willing to offer?

Members from developing countries indicated that their countries were fully aware of their temporary needs for foreign expertise and the important contribution that foreign experts could make to the acceleration of their development progress. However, they pointed out that the indiscriminate granting of tax privileges to non-permanent residents might give rise in many instances to certain difficulties. On the one hand, the problem of adaptation was not experienced to the same extent by all foreigners: experts from neighbouring countries sharing a common culture and accustomed to the same life-style would not feel completely uprooted. On the other hand, while some foreigners were experts whose services were in the host country's national interest, others carried out activities that were not of a priority character.

Some members from developing countries stated that their countries fully recognized the necessity to offer incentives to those experts whose co-operation was deemed to be valuable. However, the provision of blanket privileges was not the
best way to secure needed foreign expertise. One member mentioned that his country granted incentives to foreign enterprises according to its priorities and left to the discretion of the enterprises the question of special advantages to individual non-permanent employees of those enterprises. Another member indicated that his country granted advantages to persons strictly on a contractual basis. Several members noted that their countries granted selective tax privileges such as the deduction of educational fees abroad or travel costs. One member said that his country taxed salaries of foreign experts on the same basis as salaries of nationals but exempted the foreign experts from taxation on their income from abroad during a period of five years.

The problem was also felt in developed countries. One member from one of those countries observed that non-permanent residents are offered liberal tax deductions for special expenses such as the costs of maintaining a dual household, allowances for education abroad, travel expenses and payments to foreign insurance companies and to foreign pension and annuity programmes. In some of those situations, the benefits represented an extension of allowances under domestic laws to residents.

Some members from developing countries also voiced concern about the effect of their granting tax preferences when the taxpayer's home country operated under the tax credit system with no tax sparing. It was suggested that in such cases, the tax preferences offered by developing countries would not inure to the benefit of the non-permanent resident but instead would inure to the Treasury of the country of that person's permanent residence. In response, however, it was pointed out, first, that a treaty on the lines of the OECD Model Convention would eliminate double residence and, secondly, that most developed countries with a tax credit system only taxed the world-wide income of their "residents", which meant that persons temporarily resident in other countries would not be subject to tax on earnings from the other countries. In the case of "tax credit countries" which imposed tax on the world-wide income of their citizens irrespective of their residence, it was indicated that often a reduction in the higher taxes in the other country would simply bring the foreign tax liability to the level of that in the home country so that no advantage was obtained by the home country's Treasury.

The connexion between the taxation of non-permanent residents and the exchange of information was underlined. Several members emphasized the desirability of exchange of information so as to reduce tax evasion in the host country and to prevent the development of undesirable tax practices in the country of origin.

At the end of its consideration of the subitem the Group felt that while the subject of non-permanent residents is a matter of prime importance, it does not, at least at the present time, lend itself to solution through a model treaty provision. Initially, of course, the appropriate treatment of such residents is a matter of policy for each particular country and the treatment will be governed by the tax policy and social and economic objectives of the country. In one respect the question whether any special treatment should be accorded to such residents in order, for example, to attract them to the country or to take into account their special circumstances is similar to the general question of the desirability and use of tax incentives or preferences for certain enterprises whose presence is desired. In another respect, the question may take the form whether deductions or allowances that were granted in order to meet certain problems of permanent residents should be expanded to cover non-permanent residents facing largely similar problems but presently excluded from coverage because of the wording or details of the tax provisions involved.
It was pointed out that some countries might be hesitant to provide information on their residents temporarily located in another country if they felt that the tax laws of the latter country bore too heavily on those persons, either because of the tax rates involved or because of the effect on tax liabilities of employer payments to meet the special conditions faced by the persons in question, by reason of their transfer to or work in those countries - and on account of other such matters. Consequently, it is possible that in bilateral negotiations the linkage with the exchange of information article will result in a discussion of the treatment of non-permanent residents when that article is under consideration.
Chapter IV

ALLOCATION OF INCOME FROM THE SALE OF GOODS, THE USE OF PATENT RIGHTS AND THE PROVISION OF SERVICES

In considering this item, the Group of Experts had before it the following working papers:

"Suggested guidelines - payment for goods - technology - services" (ST/SG/AC.8/L.26); 1/

"Proposed guidelines for allocation of income from the sale of goods, the use of patent rights and the provision of services" (ST/SG/AC.8/L.18). 2/

The Group had considered the question of taxation of business profits at its First and Second Meetings at which it had agreed on the principle of taxation on the basis of permanent establishment and on a definition of permanent establishment. It had further agreed on the principle of arm's length allocation between related entities. At its Sixth Meeting the Group of Experts had discussed procedural arrangements between the competent authorities designated by the parties to a treaty concerning income and expense allocation between related entities. As a result of those discussions, the Group had devised a framework for procedural arrangements covering the entire spectrum of income and expense allocation, including transfer pricing in the area of sale of goods, use of patent rights and provision of services between related parties. At its Sixth Meeting the Group had also suggested methods for the allocation of income comprising interest on loans.

At the Seventh Meeting the Group reiterated its position that the allocation methods already devised or to be devised were to be construed not as binding rules but merely as providing the basic framework for an informed approach by tax authorities to the problems presented to them in the allocation of profits of taxpayers within their jurisdiction. With regard to the allocation of profits, the Group dealt at its Seventh Meeting with the allocation of receipts and expenses concerning payments for goods, technology and services, in the case of transactions between related entities in different countries.

The Group based its consideration of the item on the assumption that the negotiating parties would agree that the arm's length principle would govern transactions between related entities and that they would also agree to adjust the transfer prices in accordance with that principle. It was recalled that according to the arm's length principle, prices paid between related enterprises should be those that would be paid by independent parties in the same or similar circumstances.

1/ Contributed by M. H. Collins, Assistant Secretary, Board of Inland Revenue of the United Kingdom, member of the Group of Experts.

2/ Contributed by M. M. Qureshi, Chairman of the Central Board of Revenue of Pakistan, member of the Group of Experts.

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In view of the difficulties involved in formulating appropriate articulated rules on intercompany transactions between the related entities within the framework of the arm's length principle, it was suggested that the Group might consider evolving some kind of "safe havens" concept for determining intercompany pricing with respect to sale of goods, use of patents and provision of services. It was felt that such a concept would not only enable the competent authorities to take proper decisions but also give a forehand knowledge to the enterprises as regards the parameters within which they could operate.

A. Allocation of income from the sale of goods

It was agreed that the term "goods" and, possibly even more, the term "tangible assets" comprise the widest variety of items from raw materials to mass-manufactured products. It was observed that the general approach that the tax authorities of a country would take would be to determine the prices of the goods on the basis of the arm's length principle. It was pointed out, however, that tax authorities armed only with amorphous statements of general criteria would be tempted either to avoid the difficult work involved in developing specific criteria to apply in individual cases or to make adjustments aggressively based on personal notions or arbitrary measurements; in either case the result would be unsatisfactory.

The view was expressed that it would be necessary to consider the question whether goods might be supplied for no payment. Except for the provision of samples or advertising offers, however, that seemed unlikely. Another question would be whether goods might be supplied at less than the normal market price. That could happen, for example, if a company were seeking to penetrate a new market, break up an existing one or fend off increasing competition. However, it would not seem unreasonable to suggest that since those cases would be unusual, a claim that they existed and justified a comparatively low price would have to be examined closely and substantiated by cogent evidence to demonstrate that it was not a tax avoidance arrangement. A third question would be whether it would be possible for the tax authorities to accept that goods might be supplied at a price higher than the normal market price. It would be difficult to conceive of situations in which the mere supply of goods to affiliated companies would be effected at higher prices than normal market prices except where tax manipulation was involved.

There was widespread support for the view that although various methods might be used to ascertain the arm's length price, the following methods seemed to have a broad application:

1. Adopting with any necessary modifications the uncontrolled market price for the same or similar goods - the uncontrolled market price method;

2. Taking the price at which the goods are sold by the connected purchaser (the reseller) to independent customers and subtracting an appropriate mark-up in order to arrive at the arm's length price for the sale by the original vendor - the resale price method;

3. Taking the vendor's cost and adding an appropriate profit mark-up to arrive at the arm's length price for the sale by the original vendor and thus for the purchase by the reseller - the cost-plus method.
What was sometimes called the direct method of arriving at the profit of a branch or subsidiary, by apportioning to it some part of the global profits of the whole enterprise or the group, was not strictly a method of arriving at the arm's length price but was not necessarily incompatible with the objective of attributing the arm's length profit to the relevant taxpayer.

The view of the Group was that in the ordinary course of events as long as usable uncontrolled prices were available tax authorities should adopt method 1 and that only when that was not possible should the authorities resort to 2, which was less closely related to an arm's length price. Similarly 2, where possible, should be used in preference to 3. Only if methods 1, 2 and 3 could not be used should the direct method be employed.

1. The method of comparable "uncontrolled prices"

It was recalled that comparable uncontrolled market prices might perhaps be more easily found in relation to the sale of goods than in relation to many other transactions across frontiers. That might particularly be the case with natural produce or with goods manufactured for a mass market, especially if one looked at closely similar products rather than at identical ones; but there was clearly a wide range of goods where evidence of such uncontrolled sales was lacking. Where the open market was a retail market that would not be directly comparable and would in any case often display a fairly wide range of prices even for the same product.

In looking at uncontrolled market prices and prices paid by independent third parties it was necessary to look at actual prices in preference to the offers of competing sellers or the bids of competing buyers, since offers and bids were not always evidence of a firm intention to enter into a transaction.

The evidence also needed to be reasonably contemporaneous because markets fluctuated and money values changed. (That consideration was relevant also, of course, for other transfer prices, for example in the context of loans, rights or services.)

Considerations to be borne in mind in comparing the prices of the same or similar goods included the need to take account of the fact that prices in one market might vary for one reason or another from those in a different market, so that it was necessary to decide what was the appropriate market. There was an obvious need to make appropriate adjustments for different costs of transport, packaging, advertising, marketing, servicing, guaranteeing and so on which might not be included in the deal and to take account of minor modifications of the product required by the customer's Government or by the exigencies of the relevant market (e.g., car safety features). Consideration should be given to the questions whether at some particular point the differing arrangements involved or the differing modifications required rendered initially similar goods no longer sensibly comparable for this purpose. It was observed that to the extent that the differences between goods could be quantified accurately, comparisons could usefully be made between them. Unless there was satisfactory evidence of, for example, the value of a brand name or trademark it might not be useful simply to look at the prices paid in the open market for branded goods in order to calculate the arm's length price for the same goods in an unbranded package; in those cases it might be necessary, therefore, notwithstanding the fact that open market prices were fully available for branded goods, to resort to the cost-plus method or the resale method or some other method of calculating the relevant price.
Other considerations in that sort of comparison would include differences in quantity - bulk transactions could well be transacted at a discount. Evidence on which to base a discount might not be easy to find, although evidence of open market discounts in relation to sales of other goods might perhaps be helpful if treated with care.

To what extent, if any, could useful comparisons be made with prices of quite different goods, if such goods nevertheless performed the same or very similar functions? The existence of a substitute in the market might be expected to result in a convergence of the prices of the original goods and the substitute. However, consumers, persuaded perhaps by considerations of fashion, by clever advertising or simply by prejudice, might prefer to remain loyal to the more expensive product or change over from the cheaper one. The likelihood of such irrational behaviour was seen to mean that comparisons of that sort were unlikely to be helpful.

2. The resale price method

It was recalled that in the absence of evidence of comparable controlled market prices, when the goods were simply resold by the purchaser the resale price method would be easiest to use. The questions involved in such cases were likely to be restricted to matters of the reseller's distribution costs and profit mark-up. It would probably be least easy to use this method when the goods were processed and incorporated in a manufacture before being resold. In the latter case there would be the additional problem of identifying in the price of the final product those elements of cost and profit (if any) that related to the particular constituent goods. That might have to be approached in a fairly broad manner.

The calculation of the appropriate profit mark-up clearly presented problems even when the goods were resold in a largely unchanged form. The following considerations might, however, be helpful in that context.

The profit mark-up could be expected to be related to the value of the function performed by the person reselling the product. That could clearly range widely from the case in which the reseller effectively performed minimal services as a forwarding agent to the case in which the reseller took on the full risk of ownership together with the full responsibility for advertising, marketing and distributing the goods. If the reseller did no more than sell the goods again, in circumstances in which it was clear that little or no effort was needed to conclude the deal, it would be reasonable to argue that his profit would be a small one. That would particularly be the case, for example, when he had not taken delivery of the goods, but merely received and issued invoices, and was operating in a low-tax or no-tax country in which his customers for the most part did not reside. But even if the reseller did no more than sell the goods again it could be argued that his intervention had merited more than a minimal profit if it could be shown that he had had some special expertise in marketing or that some special convenience had been provided to the customer from being given the opportunity to buy the goods in that way rather than from the original vendor. Such a claim in those circumstances would, however, need to be well supported to be acceptable. It would be more easily acceptable if the reseller had been carrying on a general brokerage business - although that would be unlikely in the context of affiliated companies: in that case, however, the profit mark-up could have been related to a brokerage turn. On the other hand, when the reseller was clearly carrying on a substantial commercial activity involving such operations as the breaking of bulk, packaging,
advertising, marketing, transport, distribution and servicing of the goods, then a reasonably substantial mark-up might be expected.

The profit mark-up might be expected to vary also with regard to whether the reseller had the exclusive right to resell the goods. Since arrangements of that kind were found in the arm's length situation, the fact that the arm's length concept was being used did not make it appropriate to ignore an exclusive right of that sort. The value of such an exclusive right would depend to some extent on its geographical scope and the existence and relative competitiveness of possible substitute goods. The arrangement might nevertheless be valuable to both vendor and reseller in the arm's length situation in that it stimulated the reseller to greater efforts to sell the vendor's particular line of goods as well as providing the reseller with a kind of monopoly. In consequence, the effect of that factor on the reseller's profit margin, though it might be important in some cases, would need to be examined with care. It might in fact on balance make little difference.

In cases in which the reseller sold similar goods that he had bought at arm's length, the prices of those goods clearly might provide evidence on which to base the appropriate mark-up for the sale of goods bought from an affiliate - although it was necessary to bear in mind all the considerations relating to the comparability of goods mentioned in earlier paragraphs. But in those circumstances, since tax authorities were seeking the taxable profit of the original vendor, they might find it simpler to make direct use of the price paid by the reseller to the independent party.

3. The cost-plus method

It was recalled that the operation of the cost-plus method clearly involved the same sort of problems relating to the estimation of the appropriate profit mark-up as did the operation of the resale price method. Costs were similarly important in the resale price method because although the reselling enterprise might itself incur costs, the original vendor might incur costs on behalf of the reseller which should be taken into account in arriving at the reseller's acquisition price. In order to arrive at an arm's length price on the basis of cost plus a profit mark-up it was necessary to use the costs of the vendor only. As to how costs might be allocated between vendor and purchaser, some guidance might be derived from the "custom of the trade" where that was well established. That could be particularly relevant for transport costs, for example, but might also be relevant for other costs. In other circumstances it might be necessary to inquire for whose benefit the expense had been incurred. For example, advertising expenditure incurred for the sole benefit of the reseller of goods should not be included in the costs forming the basis of the calculation of the arm's length price payable to the original vendor. Costs in these calculations should include not only the direct cost of purchasing materials and semi-finished or finished goods and the costs of manufacture or processing and so on but also relevant indirect costs, including administrative overheads.

Tax authorities would need to consider the way in which exceptionally heavy costs, such as those of a start-up advertising campaign or the depreciation of heavy capital equipment, should be attributed to units of production. There was clearly a case in general for spreading these costs over a longer period than one year for the purpose of these calculations.
Another problem was that of the basis on which indirect costs should be apportioned—whether by reference to turnover, capital employed, numbers or costs of employees, volume of sales or other such considerations. It was clear that if any arbitrary basis were used it could produce unsatisfactory results. If, for example, world turnover was used and prices varied from country to country, costs attributed to a country in which the price was low could be regarded as unduly low even if the number of items sold had been the same in each country. Since it did not appear that any general rules could be devised, the only practicable solution seemed to be to adopt a case-by-case approach.

Where there were sales, both to independent third parties and to controlled entities, costs that did not relate to controlled sales should not be allocated to them; however, it might not be easy to make the necessary analysis. When the claim was made that research and development costs or service costs should be included, care needed to be taken to ensure that those costs had not been taken into account elsewhere. While in the case of sales of goods by a manufacturing or processing company to a marketing company, such costs might be recovered in the price of the goods, that was not always the case: sometimes a royalty or service fee might be charged or a contribution might be levied. Similarly, while payment for the use of a trademark might be included in the price charged by the owner of the trademark for the trademarked goods that he sold, again there might be a separate charge. There might also be cases where there was an interest element in the price. In all those cases care needed to be taken that payment for the right to use the trademark, patent or loan was not taken into account more than once in respect of the same goods.

A related problem might arise in the rather special case in which the goods consisted of patented machinery for use by the purchaser in the production of consumer goods under licence from the seller. Neither the seller nor the purchaser might wish to make a firm price for the machinery; in view of that, it was not uncommon for the machine to be sold at a fixed price (possibly even at cost to the seller) supplemented by payments for the rights to produce goods with it that depended on the purchaser's output or other agreed criteria. In principle, the total amount payable or estimated to be payable (including output-related or other licensing payments) should be taken into account in determining the arm's length price. While that could involve some form of capitalization of the licensing payments, tax authorities might well find it appropriate in such a case to treat the output-related or licence payments as, in effect, royalties and to regard the price of the machine itself as a separate residual item.

4. Other methods

The Group recognized that the calculation of an arm's length price was commonly a complex and tedious task not to be accomplished readily by any simple method. Some members indicated that experience had shown that, in many cases, tax authorities had to resort to "rule of thumb" practices which might differ from one country to another. It had to be borne in mind, however, that whatever method was used the overriding objective remained the approximation, as nearly as possible, of the result that would obtain in arm's length situations under similar circumstances.

At that point, reference was made to a paper entitled "Reflections on the
allocation of income and expenses among national tax jurisdictions". That paper, after raising the question whether there was an alternative course to the arm's-length approach, explored two possible allocation formulae, namely, the division of over-all profits and the division of profits accruing from particular transactions, according to such factors as sales, assets and payrolls. The paper contained the following views.

"Some have suggested the approach of an over-all division of the entire profits of an enterprise among the various units of the enterprise and thereby among the various countries in which the enterprise operates. This approach does depart from the marketplace standard. Its premise seems to be that the goal is to seek a 'fair' or 'proper' division of the over-all profits regardless of how that marketplace would operate. Under this approach a country would still not seek to rectify the unfairnesses that a market might create, as where a strong manufacturer in one country is able to impose a high price on sales to independent distributors in another country and thus place a lower portion of the over-all profits in the latter country. But if seller and distributor become part of one enterprise, then a country could under an over-all approach reform the arrangements by looking not at particular transactions but instead at the over-all profits and seeking a 'proper division' of those profits. The resulting allocation would thus generally differ from an arm's length approach. As one example, if an over-all profit existed for the enterprise, then no single unit could ever be considered as operating at a loss since the unit would be allocated some part of the over-all profit, the assumption being that all members of the group by their existence contribute to the over-all profit of the enterprise. Likewise, if there were an over-all loss, then all units ipso facto would be considered as operating at a loss. On the other hand, under the arm's length standard, some units may be seen as operating at a loss and some at a profit, regardless of the over-all figure.

"This division of the over-all profits of an enterprise, under one suggested method, would be a division along the lines of some formula. The formula, for example, could cover such locational factors as sales, assets and payroll. The basic dimensions of this task thus become clear: (1) what or who determines the over-all net profits of the enterprise (a precise mathematical figure) to be divided; (2) what shall be the factors chosen to use in the formula and how shall those factors be weighted within the formula; and (3) who shall measure those factors and then make the division. Clearly, this approach when applied to an enterprise touching a number of countries (perhaps merely more than two) requires some international authority or international arrangement to be operable, and hence at least on a short-range horizon does not seem feasible. Moreover, the theoretical premise of the approach, as stated above, requires more study.

"The approach of a division of over-all profits can be narrowed in scope from that of the profits of the entire enterprise to only the profits on transactions involving the units of the enterprise located in the two countries seeking a proper allocation with respect to those particular transactions. Thus, where a parent in the residence country and a subsidiary in the source

country are involved, the question of allocation may turn into that of a proper division of the profits from the activities in which the subsidiary participates. Indeed, the focus may be narrowed even more, and the approach used only as to certain activities, such as sales of goods by the parent to the subsidiary and re-sale by the subsidiary, and not cover other activities, such as loans made to the subsidiary or particular services rendered to it by the parent. At any event, in the context of looking only at the part of the total enterprise affecting these two countries, an over-all method would be presently manageable in the sense that only the two countries need participate. Whether the method is really manageable in practice depends on whether the over-all profits to be divided can be determined, i.e., can the pertinent segments of the parent's total activities and those of the subsidiary be separated out, and whether a proper method of division of such over-all profits can be devised.

"Here also the question can be asked whether a 'proper division of profits' is seeking the same goal as a 'proper allocation' based on the arm's length standard, or whether the profits division approach is instead attempting to impose a different division than the marketplace bargain would produce. If there is a difference, then we are forced to ask why the one approach should be used for allocations as to some types of transactions and a fundamentally different approach used for other transactions, depending on the economic form that the activities take, i.e., a unitary enterprise or independent businesses. The answers to these questions turn on what factors enter into the determination of the division of profits. It may be that factors could be sought which would approximate the division of profits produced by the marketplace. If so, these two approaches - arm's length and division of profits - become similar in theory and goal, though perhaps using different mechanics to reach that goal."

B. Allocation of income from the use of patent rights

In connexion with the consideration of this subitem, it was recalled that the Group had, at its Third Meeting, discussed the tax treatment of royalties and the interrelationship between taxation by the source country and taxation by the country of the recipient of the royalties. It was also recalled that the term "intangible property" included industrial property rights such as patents, trademarks, designs or model plans, secret formulae or processes and know-how or other information concerning industrial, commercial or scientific experiences. A patent gave a legally protected monopoly right to an invention; as to know-how, in paragraph 12 of the commentary on article 12 of the OECD Model Convention it was defined as follows: "Know-how is all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions: inasmuch as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique."

It was noted that the transfer of know-how should be distinguished from technical assistance, which constituted personal services.

The Group noted that when a parent company wanted to transfer a patent or similar intangible there were generally two methods of compensation. Under the first method the right to use the patent or intangible property was transferred to
the subsidiary either for a lump sum or for a royalty that might be a percentage of the subsidiary's gross revenue or production or a similar base. A second method, commonly used by transnational corporations, was the so-called "cost-sharing" arrangement, under which the costs of world-wide research were shared among related companies around the world.

The Group observed that intra-group contracts, which license patents or know-how, were frequently concluded between a parent company as the developer which had borne the entire costs of the development, and one or more of its subsidiaries. When groups had formed research units in different countries, subsidiaries might also license to the parent or to other subsidiaries the intangible property that they had developed. Reciprocal licensing (cross licensing) was not uncommon and there might be other, more complicated, arrangements as well.

A prerequisite for allowing payments under licensing agreements as a deduction for tax purposes was that a real benefit should have accrued or be capable of accruing to the licensee. It would normally be expected that a licensing agreement should be concluded in writing, defining as closely as possible the nature of the intangible property involved and hence providing a basis for assessing the benefit conferred. In addition, the taxpayer could properly be required to produce all the evidence needed by the tax authorities to check if a benefit had in fact been conferred on him as licensee in the particular case. It was clearly important to determine what was the underlying reality behind an arrangement, irrespective of the arrangement's formal aspect.

While it had to be demonstrated that the patent or know-how in question was in fact useful for the particular needs of the company paying for it and that a real benefit was thereby conferred, that point should not be confused with the separate matter of the calculation of what was the appropriate rate of payment to be made for that benefit.

According to the arm's length principle, if payments for the use of intangible property were deductible for tax purposes when made between unrelated companies, similar payments made in similar circumstances between related companies in a group should be treated similarly.

The Group further recognized that there were a number of forms which might be adopted in an arm's length situation. Usually, a royalty or a know-how fee would be paid, i.e., a recurrent payment based on the user's output, sales or (in some circumstances) profits or some other measure. When such royalty payments were based on the licensee's output or sales, the percentage might be degressive if that would be usual between independent parties. The consideration might also take the form of a lump-sum payment, sometimes combined with a recurrent payment. Companies might also agree on reciprocal licensing rights. The compensation for the use of intangible property might be included in the price charged for the sale of goods when for example, one company sold unfinished products to another and, at the same time, made available its experience for further processing of these products. In such circumstances any additional payments for royalties would ordinarily be disallowed by the country of the buying company; much would depend, however, upon the facts of each deal and the real value of the goods and rights transferred. There would appear to be no general principle that could be applied, except that the payment or receipt for the provision of the technology should not be included in (or, if appropriate, deducted from) the relevant receipts more than once.
The Group stressed that the arm's length consideration might sometimes be determined by looking to licence contracts that the same developer had concluded with unrelated parties involving the same or similar intangible property under the same or similar market conditions. Likewise, the offers to unrelated parties, or the genuine bids of competing licensees, could be considered when the data existed. Where the user sublicensed the property to third parties, the price paid by the latter might be relevant. The amount of consideration for similar transactions between unrelated companies in the same industry might also be a guide. In many cases, however, it would be difficult to find satisfactory comparable open-market transactions, since the owner of intangible property (and particularly the owner of a patent) was essentially the owner of a monopoly right.

The Group further agreed that it was necessary to take all the circumstances into account. That was as much the case where the evidence was provided by transactions between completely unrelated parties as in other circumstances. Since the expected profits and conditions in the relevant market could clearly affect the amount, account needed to be taken of the possibility that the fee paid in one market might not reflect the arm's length price in another. The terms on which the transfer of intangible property was made needed to be considered; limitations on the geographical area in which rights might be exercised, export restrictions on goods produced by virtue of any rights transferred, and the exclusive or non-exclusive character of any rights granted might affect the amounts payable. The value of such services as technical assistance, training of employees and so on that had been rendered by the developer in connexion with the transfer might have to be allowed for.

The Group recognized also that it was likely that an entirely new "break-through" patent that had a special distinctiveness would command a higher price than would either one designed to improve a process already governed by an existing patent or one for which substitutes might be readily available. The length of the period during which patents, know-how and so on were likely to maintain their value would also affect the amount of the payments that would be required for the right to use them. While the degree and duration of protection afforded under the patent laws of the relevant countries was variable, that factor ought to be evaluated. The process of production for which the property was used and the value it contributed to the final product had also to be taken into account. In a case in which an invention covered only one part of a complicated machine, a royalty of a small proportion of the selling price of that machine might seem reasonable at first sight but might well be exorbitant if that component was measured by reference to the value of other components and if its impact on the final product was compared to the impact of other parts. Moreover, the level of the payment for the original patent or know-how would depend on whether the licensee had the right to participate in further developments by the licensor or if, on the contrary, he was under the obligation to impart to the licensor further improvements on an invention or other intangible property.

The Group agreed that when a sufficiently similar transaction involving an unrelated party could not be found or did not provide satisfactory evidence, other methods had to be used as a means of testing whether the price actually paid by the licensee was acceptable to the tax authorities. Usually it would be necessary to take account of more than one method in reaching a satisfactory approximation to the arm's length price. An approach often employed in practice was to make a pragmatic appraisal of the trend of an enterprise's profits over a long period in comparison with those of other unrelated parties engaged in the same or similar activities and
operating in the same area. There could, of course, be many reasons for an unusual profit situation and it might be possible for the taxpayers to give satisfactory explanations for particular cases. The profit comparison approach thus provided no more than an indication that the consideration charged for the use of intangible property might or might not be reasonable.

The Group was also of the opinion that it might be useful to look at the costs incurred by the licensor in developing the property. However, the actual arm's length open-market price of intangible property was not related in a consistent manner to the costs involved in developing it. If the research resulted in a successful (i.e., profitable) product the price would exceed the cost, possibly by a very large margin. Less successful products might recover less than the cost of the underlying research. Moreover, if any research activity was to be carried on at all the cost of successful research might often have to include the cost of unsuccessful research. The uncertainties attendant on the eventual return on expenditure on research and development and the length of time during which a patent would prove to be commercially usable together with the monopoly element present in patent licensing made reference to cost hazardous. Moreover, it might not be easy to determine what the costs connected with the development of a particular item of intangible property were when research was performed in a group on a large scale and for various purposes. Despite those difficulties, there might be cases in which the cost-oriented method gave some guidance, at least as regards the lower limit for the licensor's profit in normal circumstances.

It was recalled that companies used cost-contribution arrangements to finance expenditure on research and development as or before it was incurred instead of selling or licensing patents or know-how after they had been successfully developed. Although not numerous, cost-contribution arrangements fell into two main categories. There was, first, the cost-sharing arrangement under which members of the group agreed to share the actual costs and the risks of specific research and development undertaken for the benefit or expected benefit of each of them. In such cases, each participant would bear its fair share of the costs and risks and would in return be entitled to its fair share of any usable results of the research and development. The arrangements resembled in some respects a joint venture or partnership. Secondly, there was what might be described as the cost-funding arrangement (which would be very unusual among unrelated companies), under which members of the group contributed in a more general way to the cost of the research and development programme of the group. Usually that contribution would take the form of a generalized fee and would not be related to the actual cost of any specific research and development activities. In such cases, the actual results of the research and development might well be owned by a single company - frequently the parent company - which would have the primary responsibility for the patent, although the results, if any, of the research and development would usually be made available to all the contributing members of the group.

The Group felt that countries would have to decide how far payments of that sort could be accepted for tax purposes.

Some countries had special rules for cost-sharing arrangements. Under certain conditions companies taking part in such arrangements were allowed for tax purposes to charge or to deduct as expenses the actual costs involved without the addition of a profit mark-up. The explanation for that was that various forms of cost-sharing arrangements existed in practice in those countries and, in so far as the
arrangements were consistent with the arm's length principle, a need was felt to accommodate the existence of such arrangements in the regulations.

Concerning the terms and conditions of cost contribution, the Group recognized that arrangements might be examined in each particular case to determine whether the research was actually performed in the interest of and for the real benefit of the respective parties; in that sense a potential benefit would be a real benefit. Thus, inter alia, the research carried out would have to be closely related to the specific needs of the participants. The terms and conditions of an arrangement might be comparable to those which would have been adopted by unrelated parties under similar circumstances. Cost-contribution arrangements between independent parties were uncommon except in the case of special projects, so that it would have to be established that the various participants were really in a position to benefit from the various research projects. Normally it would be expected that only manufacturing companies would be found as participants in a cost-contribution arrangement, since trading companies would expect to recover their cost in the price of the goods sold; however, there might be exceptions. The contributions by participants ought to be made for research projects in which they were in fact interested and should not lead to an excessive build-up of funds in the hands of the research company. It would normally be reasonable to expect that the terms of a cost-contribution arrangement would be laid down in a written contract concluded in advance. In addition, it could be expected that the participants in the cost-contribution arrangement would be able to demonstrate that the research and development they were paying for was in conformity with the written agreement and had been or would be carried out in practice. It would be for the company to produce, at the request of the tax authorities concerned, all the evidence needed to prove that the research had been carried out in its interests and in anticipation of real benefits. There again, it was more important to look at the substance than at the form of an arrangement.

The Group felt that it could reasonably be expected that a contribution of that sort could be designed to recover not only the direct costs but also some, at least, of the indirect costs of research and development. Indirect costs would be those that were not specifically identified with a particular research or development activity but that related to the direct costs. They would thus include costs with respect to supervisory, clerical, administrative and other overhead activities. Costs of a capital nature, such as expenditure for buildings, machines and other assets necessary for the research, and possibly interest attributed to capital account whether capitalized or not, might be allocated on the basis of the relevant allowances such as those for depreciation of property. Recognition might have to be given to special allowances for capital costs for research and development. In a cost-sharing arrangement, only net costs would be subject to allocation, the costs of research at request being charged directly to the requesting party, with any licence receipts or receipts from the sale of research assets being deducted from the amount to be allocated among participants. Any subsidies granted to the developer by a Government would also be deducted. Any excess of receipts over gross costs in any year would normally be distributed, or credited, to the participants in the arrangement. In a cost-funding arrangement, the answer to the question whether, and to what extent, the remuneration received by the research company from third parties or Government subsidies ought to be considered as reducing the contribution, might depend upon the formula adopted for the calculation of contributions by the Group.
The Group recognized that it was possible to have differing views on the question whether the contributions of the participants in a cost-contribution arrangement should include a profit element. There was a prevailing view that in cases where research and development were carried out to order, the firm carrying out the research or development activity should be expected to carry it out for the profit and thus should charge, in addition to costs, a profit mark-up. It would follow that the profit mark-up would then form part of the expenses incurred by the contributing companies. To the extent that the company carrying out the research was relieved of risk because it could rely on its costs being met by the participating companies, it seemed right that any profit mark-up should not take account of such risks and that it ought to be limited to a reward for its activities in organizing and managing the relevant research project or projects. Separately incorporated research companies supported by contributions from affiliated firms would carry out research in the interest of other members of a group and would not use the results of the research and development for their own purposes. Such research companies should ordinarily be required and allowed therefore to charge costs plus a profit mark-up to reflect their efforts in organizing and managing the research effort.

The Group also recognized that the costs of research and development had to be allocated in a fair and equitable way to the participants in a cost-contribution arrangement. There was no formula that could be universally applied, since the circumstances might vary considerably. Some groups allocated costs in proportion to the expected benefits to the parties involved: that seemed a reasonable approach. Others allocated costs according to the proportionate turnover of the participants. That rule of thumb might provide a reasonable measure of eventual benefits conferred but it might also lead to distortions, so that that type of allocation formula would have to be scrutinized closely by the tax authorities in the countries concerned.

Members from developing countries pointed out that, in most instances, transfer of technology took place with considerable delays, after research and development expenditure had presumably been recouped through sales or other activities in the home country or elsewhere and that therefore such expenditure should not be considered allocable to the determination of the net royalty in the source country. That position was based in part on the view that such recoupment of expenditure through activities in the home country or elsewhere left the patent available to earn receipts in the source country which involved no possibility of loss to the licensor in view of the previous recoupment. That position was also based on the view that such expenditure, although not recouped, had been "written off" for tax purposes in the home country. However, it had generally been agreed that such rapid "writing off" made in the home country to encourage research or because it was difficult to forecast revenues from research, should not prejudice the case of the source country, in comparison with a case in which write-off was spread more evenly over future revenues. Since in such a situation the write-off resulted in a deferral of the tax of the source country, it should not militate against allowances of the expenditure in other jurisdictions. It might, therefore, be appropriate to regard the recouped or written-off expenditure as allocable to all the receipts at home or abroad that were derived from patents or assets arising from the expenditure, especially since the expenditure involved in research and development might not be identifiable with the development of a particular patent or a technical process. In finding the net royalty in the source country, the deduction of recouped expenditure against each use of the patents - past, current or future - would thus dilute the allocation. Such a deduction would also mean allocating a comparatively
smaller allocable figure to the portion to be borne by future receipts, with the older patents thus attracting a much smaller deduction in respect of the expenses incurred in the development of such patents. One member expressed the opinion that there should be no payment at all for patents presumably already written off in the home country.

C. Allocation of income from the provision of services

It was pointed out that although some services might be provided within a transnational enterprise which were clearly of the same nature as those provided by independent companies, others were more specific to transnational corporations and arose from the fact that multinational groups constituted an economic unit in which all entities were subject, to some extent, to an over-all plan drawn up in the interests of the strategy of the group controlled by the parent company. For that purpose, the group had to maintain staff and equipment, at headquarters or otherwise, for the supervision of and provision of assistance to other members of the group. When assessing the taxable profits of the latter, the tax authorities of the countries concerned would have to decide, in accordance with the arm's length principle, whether by nature the services rendered were of a kind to justify some payment or contribution by the company under consideration and whether a real benefit was conferred.

It was noted that the provision of services within a group could be organized in various ways. While specific services would generally be rendered by a parent company, it could also happen that a subsidiary rendered services to its parent or to other affiliated companies or that services were performed reciprocally. Some groups had established separately incorporated service companies (which could, for instance, take the form of joint stock companies or of partnerships).

It was further indicated that a first category of services performed in a transnational or multinational group comprised services undertaken by the parent company in its capacity as shareholder; it included audit activities performed by the parent company to inform itself about the financial situation of a subsidiary and the relevant reporting processes, the preparation of the parent company's own shareholders' meetings and the selection and appointment of directors of subsidiaries; similar costs might be incurred by the parent company, or by an intermediate holding company, for the co-ordination or control of the various interests in a way not amounting to a controlling participation in other companies.

A second important category covered the range of services that a parent company might perform in its role as the co-ordinator, supervisor and initiator of the group's activities. Such services would include the basic organization of the group (for example, the arrangement of capital increases or loans for subsidiaries, the creation of new companies, the acquisition and disposal of old companies, mergers etc.). They would also include centralized planning in fields such as finance, investment, production, marketing, joint advertising or market research, consolidated accounting and centralized public relations. Those "management" services might be seen as benefiting the group as a whole; but it might be arguable that to some extent a number of them were of direct benefit to particular subsidiaries. The expenditure involved might well, however, be capital rather than revenue in some cases.
A third category of services whose organization might be either concentrated at the parent company level or delegated to specialized companies in the group consisted of the provision of services "on call" which could be rendered on an arm's length basis between independent firms. That covered activities such as the provision of financial resources of commercial, organizational or technical experience, of computer services and of legal, accountancy or tax services. Companies in a group might also provide services for each other in other ways - lending or hiring each other staff, equipment etc.

The Group observed that the problem of classifying the services for the purpose of fixing a charge was not an easy one. It needed to be ascertained whether, in the first instance, any services were performed at all and, if so, whether the services rendered had any connexion with the activities of the paying corporation.

With respect to the allocation of costs within a group, it was pointed out that specific services directly rendered by one member of the group to another represented only a limited part of the whole "provision of services" in a group. The costs of management, or of "central" services, which were in the first instance often borne by the parent company (or a specialized company) might represent substantial amounts, which the company would need to recoup from other companies. Companies might be tempted to recover cash flows from abroad through such sharing of costs rather than through obtaining dividends from the subsidiary. It was necessary therefore to look carefully at the cost-allocation system adopted.

On the one hand, some transnational companies considered that overhead costs were incurred primarily to benefit the parent company and that they should not be fully attributed to the affiliated companies.

On the other hand, other transnational corporations followed cost allocation concepts without any distinction as to the nature of the service expenditures. They argued that distinguishing between costs would not correspond to the economic realities, since all the activities of the parent were performed in the interest of and for the benefit of the entire group. Such groups were likely to allocate all costs in proportion to the sales or to the turnover of the respective affiliates or on some similar general basis. Some cost-allocation systems were limited to services and related activities. Alternatively, the transnational corporation might make a package deal, under which subsidiaries paid a flat fee as remuneration for the right to use patents, know-how, trademarks and so on and received a variety of services.

It was acknowledged that the general principle which competent authorities should keep in mind while making allocation was that if services were rendered for the benefit of the subsidiary, the arm's length charges for them should be considered as deductible expenditures by the subsidiary but that if they were rendered for the benefit of the parent company they should not. In any case, it would not be appropriate to regard benefit as having been conferred if the benefit were too indirect for unrelated parties to be likely to have agreed to charge or to pay for similar services. A service that duplicated a service being performed by the related party, or that the related party was already having performed by a third party, would also not seem to provide a benefit for the related party.

A useful pointer as to whether to accept that a service had been rendered for the benefit of a subsidiary might be whether, in similar circumstances, the
service would have been provided where the parties were independent. It could not
be taken for granted that transnational corporations should be able to recover the
whole of their central expenses, including costs of control, on the grounds that
all these activities benefited the affiliates and that in application of the
arm's length principle in international tax law, those activities should be
remunerated. While some of the service activities of the parent company promoted
the performance of the group as a whole that did not necessarily imply that such
activities were undertaken in the interest of the individual affiliated members.
Such activities might even have a negative impact on a subsidiary, as, for example,
would be the case if the top management of its group decided that another
subsidiary should get the order to construct a plant or that it should buy its
raw material from a related company at prices higher than market prices.

The Group recognized that the general rule that no charges should be allowable
unless they were related to a service actually performed was fully applicable in
that instance.

It recalled that, in accordance with the arm's length principle, prices for
services performed between related parties should be those that would be paid
between independent companies and that such transactions should not be treated
differently for tax purposes from similar transactions between independent parties,
simply because the companies happened to be affiliated.

As to the form of payment, it would ordinarily be expected that specific
services would be charged individually to the recipient of the services. But
payment by way of a flat fee for entitlement to services that were provided
automatically or continuously or at call might be met with and such a form of
payment would be acceptable if, under similar circumstances, unrelated parties
would have fixed the price in that manner. Care should be taken that non-duplication
of deduction should occur where the remuneration for services was already included
in the price for other transfers (licence fees, price of goods etc.).

In determining the amount of the consideration under the arm's length
principle, it might be possible in many cases, especially where commercial and
technical assistance were concerned, to make comparisons with prices charged
between independent parties for similar transactions. With regard to administrative
and managerial services, such comparisons were likely to be more difficult; but
similar transactions between unrelated parties did occur. Where such evidence was
lacking or was unsatisfactory it might be helpful to look at the price charged for
services performed by the providing company for unrelated parties - bearing in
mind, however, the considerations involved in using that kind of evidence.

The Group pointed out that frequently it would not be possible to find a
sufficiently similar open-market transaction with which to compare the service fee
agreed upon by related parties and that then it would be necessary to resort to
the analysis of the costs of services rendered between related entities, which
might include both direct and indirect costs. The direct costs would be only
those costs that could specifically be identified with a particular service,
including costs or deductions for compensation, bonuses, travel expenses
attributable to employees directly engaged in performing such service and costs
of material and supplies directly consumed in rendering such service. Indirect
expenses might be those that were not specifically identified with a particular
activity or service but related to the direct costs; these might include management
expenses, financial charges, housekeeping expenses, advertising expenses and so on.
The latter would include an appropriate share of the costs relating to supporting parts of the organization and other applicable general and administrative expenses, to the extent reasonably allocable to a particular service.

The next question for determination of a proper charge was whether the proper charge should include the cost only or in addition a profit mark-up. Countries were apparently divided as to the appropriate charge. With respect to the parent company, some countries would require no more than a charge based on cost to the parent (unless the parent or the subsidiary were engaged in the commercial activity of providing such services generally). The services would be regarded as ancillary in nature and the profit element would be confined to the main activity of the parent, such as the sale of goods. Other countries, stressing more heavily the force of the arm's length standard, would require a profit mark-up for such services.

The country of the subsidiary must also consider whether it would accept as deductible a charge involving a profit element or whether it would feel that a charge based on cost only was proper.

There was little disagreement that a profit mark-up might be included when such services formed an integral part of the business of the enterprise but some members thought that when the services were ancillary to the main business a profit mark-up was not appropriate. As one reason for this one member from a developed country stressed the logical consistency to be maintained between the services and the interest on loans, in connexion with which the Group had already agreed not to include the profit element.

Some other members felt that it was perhaps unlikely that a company in the arm's length situation would provide services merely for cost (even if the provision of such services was not a main part of its business) if it was particularly capable of supplying the relevant services and the value of the services to the recipient was considerably greater than the cost or if the cost of the services represented a substantial proportion of the expenses of the recipient's business. Tax authorities might expect therefore that where affiliated companies were in that position, the charge for the services would include a profit mark-up.

One member stressed that the disallowance of charges for services might be appropriate where the parent fully controlled the subsidiary.

Some members from developing countries expressed the opinion that the question was somewhat theoretical, since experience showed that services performed for subsidiaries by parents were supported by claims that the charges, although seemingly at a high level, in fact represented the parent's costs.

Finally, the question was raised whether the reference market should be that of the renderer or of the beneficiary of the services. It was observed that in many cases, as far as developing countries were concerned, there was little likelihood that such services would be available in the subsidiary's country. However, should such services exist in that country, there was a general agreement that its market would serve as reference. One member from a developed country observed that the stress placed on the local market produced a different result from that of the treatment of interest, where stress was placed on the conditions in the country of the lender.
In conclusion, while most members from developed countries thought that a profit charge was appropriate and many members from developing countries agreed with that view, there was a wider range of opinions among the members from developing countries than among those from developed countries.
Chapter V
DETERMINATION OF PROFITS AND TAXATION OF ROYALTIES IN THE CASE OF CONTRACTS FOR THE PROVISION OF EQUIPMENT AND/OR SERVICES

In considering this item the Group had before it a working paper entitled "Note concerning the determination of profits and the taxation of royalties" (ST/SG/AC.8/L.22). 1/

A member from a developed country introduced the paper and pointed out that his country was having some problems with inconsistent determinations of the profits properly attributable to a permanent establishment, especially with regard to "turn-key" contracts. It was recalled that under a turn-key contract a contractor agreed to construct a factory or similar facility and make it ready for operation. When the facility was ready for operation, it was handed over to the purchaser, who could then begin operations. The international tax problems occurred when the facility was to be constructed in one country by a contractor resident in another country. The actual construction activities carried on in one country clearly constituted a permanent establishment within that country if of sufficiently long duration. Turn-key contracts, however, were often concluded before the creation of the permanent establishment and involved many components other than normal construction activities. They also included the purchase of capital goods, the performance of architectural and engineering services and the provision of technical assistance. Those latter items, it was explained, were sometimes completed before construction activities actually started (and hence, before the creation of a permanent establishment at the construction site) and often outside the country in which the construction site/permanent establishment was situated.

The question thus arose as to how much of the total profits of the turn-key contract was properly attributable to the permanent establishment and thus taxable in the country in which it was situated. A member from a developed country said that he knew of instances in which countries had sought to attribute the entire profits of the contract to the permanent establishment. It was his view, however, that only the profits attributable to activities carried on by the permanent establishment should be taxed in the country in which the permanent establishment was situated, unless the profits included items of income dealt with separately in other articles of the Convention and were taxable in that country accordingly.

The Group recognized that the problem described above was a complex and potentially controversial one involving many interrelated issues, such as source of income rules and the definitions of permanent establishment and profits of an enterprise. The Group therefore decided to defer discussion of that problem until it had been studied more fully.

The Group also considered a problem involving the broad definition of royalties. A member from a developed country explained that in his view the problem was that the definition made an imperfect distinction between revenues that constituted royalties in the strict sense and payments received for brain-work and technical services, such as surveys of any kind (engineering, geological research etc.). The member also mentioned the problem of distinguishing between royalties akin to income from capital and payments received for services. Given the broad definition of "information concerning industrial, commercial or scientific experience", certain countries tended to regard the provision of brain-work and technical services as the provision of "information concerning industrial, commercial or scientific experience" and to regard payment for it as therefore taxable as royalties.

In order to avoid those difficulties, the member from a developed country proposed that the definition of royalties be restricted by excluding from the definition payments received for "information concerning industrial, commercial or scientific experience". The member also suggested that there be a protocol annexed to the Convention making it clear that such payments should be deemed to be profits of an enterprise to which article 7, dealing with business profits, would apply and that payments received for studies or surveys of a scientific or technical nature, such as geological surveys, or for consultant or supervisory services, should be deemed to be profits of an enterprise to which the provisions of article 7 would apply. It was pointed out that the effect of those different provisions would be to ensure that the source country could not tax such payments unless the enterprise had a permanent establishment, as defined by the Convention, situated in that country, and that taxes should be payable only on the net income element of such payments attributable to that permanent establishment.

On the other hand, a member from a developing country pointed out that the narrower definition of royalties suggested by the member from a developed country would help to clarify the interpretation of article 12, paragraph 2. But if the definition of royalties was left unchanged in the OECD Model Convention, he understood that brain-work and technical services would be covered by the expression "information concerning industrial, commercial and technical experience", and as such would be included in the definition of royalties.

The Group recognized that the problem of defining royalties was a complex and controversial one and therefore deferred a thorough discussion of the problem until such time as it had been studied more fully.
THE QUESTION OF EXCHANGE OF INFORMATION FOR THE PREVENTION OF INTERNATIONAL TAX EVASION INCLUDING RECURSCE TO TAX HAVENS

In examining this item the Group of Experts had before it a working paper entitled "Proposed guidelines for exchange of information for the prevention of recourse to tax havens". 1/ That paper dealt with two intertwined issues, namely, recourse to tax havens for tax avoidance purposes and the exchange of information for the prevention of tax evasion. It observed that experience had shown that in both developed and developed countries the application of the arm's length principle was not easy even in purely domestic situations. The difficulties increased when international transactions were involved. In addition to encouraging legal methods of reducing tax, the existence of tax-haven countries made tax evasion highly tempting. The result was that quite often fictitious entities were set up in tax-haven countries. 2/ The tax avoidance devices generally adopted were the following:

(a) Payment of deductible expenses by an entity of a high-tax jurisdiction to a tax-haven entity;

(b) Transfer of income-producing assets or income-producing functions to the tax-haven entity;

(c) Use by the transnational corporations of an "insulator" somewhere along the line of their transactions so as to make investigation and proper assessment more difficult. (Quite often, that insulator was located in a tax-haven country, either because the laws of that country were lenient or because the authorities were more friendly);

1/ Contributed by S. Narayan, Chairman of the Central Board of Direct Taxes of India, member of the Group of Experts.

2/ In that connexion, the Group heard a statement by the observer for the United Nations Conference on Trade and Development (UNCTAD) who informed the Group that the UNCTAD Committee on Shipping had at its sixth session requested the UNCTAD secretariat to prepare a study on the economic consequences of the existence or lack of genuine link between the vessel and the flag of registry. That study had been submitted to the eighth session of the Committee on Shipping, in April 1977. The Committee had decided that an ad hoc intergovernmental group on the subject be convened in 1978 to consider it thoroughly. That meeting was scheduled for February 1978. The UNCTAD observer pointed out that the fleets of the so-called open-registry countries had accounted for 31 per cent of the world fleet in 1976 and that the UNCTAD study had found that open-registry countries (providing flags of convenience) were attractive primarily for two reasons:

(1) Lack of financial control and the possibility of tax evasion; and

(2) Lower Manning costs, due to the possible recruitment of seamen from developing and less advanced countries and almost no taxation on their incomes.
(d) Shifting by a transnational corporation, through the device of
manipulation of transfer pricing, of its income from a high-tax country to a tax
haven or to a country granting complete exemption for periods ranging from
5 to 10 years to income from business in certain specified areas;

(e) Overstating or understating of the true value of exports and imports,
often through collusion with affiliates and not infrequently by incorporating in
the chain a business enterprise in a tax-haven country; and

(f) Under-capitalization of companies. (The motive in providing capital in
the form of loan rather than as equity was to enable the entrepreneur to withdraw
future earnings as repayments of loans rather than as taxable dividends).

The working paper first stated that the basic information in the formulation
of draft guidelines for the exchange of information for the prevention of recourse
to tax havens was largely the same as that for the general article on exchange of
information in any bilateral tax treaty; then the working paper noted that the
Group of Experts had at its sixth meeting worked out guidelines in the form of
an inventory of possible arrangements from which the tax authorities might select
those arrangements that they decided to utilize to implement the various treaty
provisions. According to the working paper, it would seem necessary that if
the exchange of information was between two States, one of which was a low-tax
country, the following information, inter alia, should be transmitted:

(a) Name and address of the company, agent, investment trust etc.

(b) In the case of a company, issued and paid-up capital, names and
addresses of shareholders together with details of shareholdings; in the case of
other entities, information regarding persons concerned and their financial
interest.

(c) Nature of business, whether holding investments, manufacturing, trading
or servicing.

(d) Amount of loans and bank borrowings; in the case of loans received,
necessary details of persons concerned and the amounts in each case; in the case
of bank borrowings, details of collateral securities wherever deposited; in the
case of advances, details of the securities against which advances have been made
showing their ownership.

(e) Countries with which substantial activities are carried on. In
particular, the total investments made country-wide and the total sales effected to
each country. Such information may enable the home country to consider the
applicability of its measures for purposes of tax avoidance.

(f) In case of assets, names and addresses of the real owners with full
details of their holdings.

(g) The quantum of total income under specific heads, such as different
businesses, commission, interest, property etc. admitted each year.

The working paper stated that bilateral treaties should permit the exchange
of information among more than two States linked together by a network of bilateral
treaties, even though that network might not be complete, and that it was axiomatic
that there should be full knowledge about the tax laws of the other countries; it also stated that any exchange of information would not serve much purpose if it were not provided that the Contracting States would also render assistance in the matters of collection and recovery of taxes.

The working paper referred to subparagraphs (a) and (b) of paragraph 2 of article 26 of the OECD Model Convention. Those subparagraphs read as follows:

"2. In no case shall the provisions of paragraph 1 be construed so as to impose on one of the Contracting States the obligation:

(a) To carry out administrative measures at variance with the laws or the administrative practice of that or of the other Contracting State;

(b) To supply particulars which are not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;"

The working paper stated that those provisions restricted the obligation of the Contracting States in the following two ways:

(i) The use of the words "the administrative practice" and "in the normal course of the administration" would mean, as indicated in the relevant commentary on the OECD Model Convention, that only that information would be supplied that could be obtained by them in the normal procedure of tax determination - but not if it could not be obtained without special examination of the business accounts kept by the taxpayers or other persons;

(ii) Use of the words "of that" or "of the other Contracting State" would mean that the obligation was limited to the supply of information that could be made available on a reciprocal basis. (As the commentary on the Convention stated, if the structure of the information systems of the two Contracting States was very different, the conditions under subparagraphs (a) and (b) would allow the Contracting States to exchange very little information or perhaps no information at all.)

The working paper stressed that awareness of the need for and importance of close co-operation among States was a prerequisite for any meaningful convention on exchange of information for prevention of tax evasion. Such co-operation could and should take the form of joint administrative action in various fields in which action on the basis of the traditional treaty might prove inadequate. Psychologically a public declaration by all States of their refusal to acquiesce in the growth of international tax evasion and of their common determination to take action to eradicate or at least to reduce it to the minimum would undoubtedly make a great impact and create the right climate for negotiating the treaties.

The working paper contained the following proposed guideline in the form of a draft article on exchange of information which would be in fact a revised version of article 26 of the OECD Model Convention.

"1. (a) The competent authorities of the Contracting States shall exchange such information as is necessary for the carrying out of this Convention and
of the domestic laws of the Contracting States concerning taxes covered by
this Convention in so far as the said taxes are in accordance with this
Convention, in particular for the prevention of fraud or evasion of such
taxes as well as for rendering administrative assistance in the matters of
recovery and collection of taxes. Any information so exchanged shall be
treated as secret and shall not be disclosed to any person other than those
authorities (including a court or administrative body) concerned with the
assessment, collection, enforcement or prosecution in respect of the taxes
which are the subject of the Convention. However, the information so
exchanged by the two Contracting States may be transmitted by any of them to
any other State with which it has a Double Taxation Avoidance Convention
providing for exchange of information provided that the said other State
agrees to treat the information as secret in the same manner as the two
Contracting States to this Convention have agreed.

(b) The exchange of information shall be either on a routine basis or on
request with reference to particular cases or both. The competent authorities
of the Contracting States shall agree, from time to time, on the list of
information which shall be furnished on a routine basis.

(c) Where the tax administration of any Contracting State has developed
information in the course of investigation or other proceedings carried on by
it, which it believes would be of assistance to the tax administration of the
other Contracting State, the competent authority of the first mentioned State
shall furnish such information to the competent authority of the other State
even without any request in this behalf from the latter.

(d) The competent authorities of the Contracting States shall notify
each other at least once a year of amendments, if any, of the tax laws relating
to the taxes covered by this Convention, by transmitting the texts of the
amendments or new statutes enacted to levy such taxes. The competent
authorities shall also exchange the texts of all published material
interpreting the present Convention under their respective laws whether in the
form of regulations, rulings or judicial decisions.

2. (a) The Contracting States shall render each other assistance and support
in the collection of taxes, duties, surcharges, overdue payments, penalties,
interests and costs in accordance with their legislation, where such sums are
finally due under the laws of the applicant State.

(b) Applications for such assistance shall be accompanied by documents
required under the laws of the applicant State to establish that the sums to
be collected are finally due.

(c) On receipt of these documents, the State applied to shall serve writs
and take measures for the levy and collection of the taxes in accordance with
the laws governing the levy and collection of its own taxes. In particular,
writs of execution shall be drawn in the form prescribed by the statutory
provisions of that State.

(d) Where a tax claim has not become final by reason of its being a
subject of appeal, an Acceding State may, in order to protect its rights,
request the other State to take such interim measures in this behalf as are
lawful under the legislation of the latter State.
(e) An application for assistance in recovery of tax shall be made only if there are no satisfactory means of recovering the tax in the applicant State.

(f) The State in which tax is recovered in pursuance of this Convention shall be liable to the other State for the amount recovered.

"3. In no case shall the provisions of paragraph 1 be construed so as to impose on one of the Contracting States the obligation:

(a) To carry out administrative measures at variance with the laws of that State.

(b) To supply particulars which are not obtainable under the laws of that State.

(c) To supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process or information the disclosure of which would be contrary to public policy (ordre public)."

During the ensuing discussion, the Group was reminded that OECD had amplified both the article on exchange of information and the commentary thereon to liberalize the restrictions on exchange of information referred to in the working paper's comments (i) and (ii) (given above) on subparagraphs (a) and (b) of paragraph 2 of article 26 of the Convention. It was recalled that those matters had already been the subject of discussion at the Sixth Meeting of the Group when the latter had accepted the OECD liberalization. 3/

The Group's attention was drawn to the Recommendation adopted by the Council of the Organisation for Economic Co-operation and Development on 21 September 1977. The Council, having considered, inter alia, that tax avoidance and evasion schemes involving international transactions had become increasingly complex and more difficult to detect, recommended Governments of member countries:

(a) To strengthen, where necessary, their legal, regulatory or administrative provisions and their powers of investigation for the detection and prevention of tax avoidance and evasion, with regard to both their domestic and international aspects, and to exchange experiences with respect to such action;

(b) To facilitate, improve and extend exchanges of information between their national tax administrations, with a view to combating tax avoidance and evasion, notably by making more intensive use of international conventions or instruments in force and by seeking new arrangements of a bilateral or multilateral character, with due regard to the provision of adequate safeguards for taxpayers;

(c) To exchange experiences on a continuing basis on tax avoidance and evasion practices, on techniques for detecting and preventing them and on ways and means of improving tax compliance in general.

The Council also instructed its Committee on Fiscal Affairs to pursue its work with a view to facilitating the achievement of the above aims and to submit to the

Council, as appropriate, specific proposals for increased co-operation between member countries in this field.

The Group agreed that a major issue with respect to international income allocation for both developed and developing countries was related to the volume and quality of information available to tax administrators. One member reminded the Group that the tax inspector who audited a permanent establishment or a subsidiary of a foreign enterprise might receive information from three sources:

1. Governmental services such as customs administrations or foreign exchange offices;

2. Books kept and statements made by the taxpayer himself;

3. Foreign tax authorities (subject to the existence of a tax treaty and the kinds of information dealt with therein).

With respect to information gathered from customs declarations, one observer from a developing country expressed serious reservations about its significance for tax purposes. One member from a developed country said that in his experience it was not always easy to match the customs information with the kinds of information that an inspector needed. It was indicated that the interest of the taxpayer in filling out his declaration for ad valorem customs duties was at variance with his interest in filling out his income tax declaration and that it was known that information could be exchanged between customs and income tax authorities, more realistic declarations might be made for both purposes.

With regard to information derived from books and statements, the view was expressed that it might not always provide a realistic picture of the true underlying facts. Modern standards of accounting, including the use of data processing machines, did not exclude results not in accordance with the law. It would be naive to believe that tax administrators dealing with international transactions could achieve better results than tax administrators concerned only with transactions between related enterprises within their national boundaries. Even private auditing firms departed substantially in some cases from results found by the tax inspectors. There was a further view that the information derived from books and records might even be completely misleading when a company situated in a tax haven was used to siphon off the profits from an international transaction between companies situated in higher-taxing countries.

With respect to information to be obtained from foreign tax authorities, the Group felt that stronger and more active co-operation between tax administrators was necessary in order to cope with the extremely complex problem of transfer pricing and international income allocation. One member from a developing country mentioned that the developed country in which the parent company was located had a much simpler task in obtaining information on the global activities of the parent company than did the developing country in which a subsidiary or a permanent establishment was situated.

The view was expressed that requested information should be provided even when the information did not relate to a current tax interest of the requested State, so long as the request met the conditions set forth in the article.
Concerning the above-mentioned possible guideline which was presented in the form of a draft article on exchange of information, the discussion centred first on the last sentence of subparagraph 1 (a) of that article. One member from a developed country observed that it involved two conflicting basic desires: the desire to obtain information as complete as possible and the desire to ensure that the information should not be abused in passing from one country to another. That view was practically shared by most members from developed countries. One of those members noted that the sentence was unnecessary in the case of perhaps the most typical triangular case that would involve a tax haven, that is, treaty countries A and B exchanging information regarding their enterprises with activities in the tax-haven country. It was recalled that the possibility of triangular exchanges of information had been discussed at the Sixth Meeting 4/ and that it had been agreed that multilateral exchanges of information should be allowed only with the consent of the tax authorities from which the information was originally obtained and then only if the secrecy of the information had been adequately safeguarded. The dominant feeling of the Group as a whole was that such a view still reflected its position.

Concerning subparagraph 1 (b) of the draft article, many members felt that the exchange of information carried out mandatorily on a routine basis might not be as useful as information produced by specific requests. The routine exchange of information might also create unnecessary administrative burdens for the tax authorities of both Contracting States. It was therefore thought that it would be more useful for States to concentrate on specific requests for information rather than routine transmittals.

Concerning subparagraph 1 (c) of the draft article, one member considered that a very complex problem would be to know which authority or which service in one Contracting State should decide on the kind of information to be transmitted to the other Contracting State. Other members noted that such a subparagraph would require that information be exchanged even though the information was not covered under a routine transmittal programme or was not specifically requested. Thus a competent authority would be required to send information it had collected that would appear to be of interest to the competent authority of the other Contracting State. It was generally felt that transmittal of requested information should be discretionary.

One member of the Group suggested that subparagraph 1 (d) of the proposed exchanges of information article would not be especially useful. Under that subparagraph competent authorities would undertake to keep each other advised of changes in the tax laws and procedures. With the increasing sophistication and thoroughness of commercial tax services, however, it did not appear necessary to put that additional administrative burden on the tax administrations.

It was observed that paragraph 2 of the proposed article on exchange of information would impose on each Contracting State the obligation to render assistance in the collection of taxes. One member said that tax administrators in his country did not have the constitutional authority to collect foreign taxes. Other members indicated some reluctance to accept such a broad obligation to collect foreign taxes; they thought that on the one hand the tax administrators might lack the authority to do so and on the other that it would impose an additional

burden on them. Therefore one member proposed a limited collection assistance provision under which the Contracting States would agree to collect the other country's tax when persons had improperly or incorrectly obtained the benefits of an exemption or reduced rate of tax offered by the other country under the tax treaty. That limited collection assistance provision, it was felt, would offer some protection against improper manipulation of treaty benefits.

It was pointed out, however, that since the language used in the collection assistance provision would be less than mandatory, in some countries domestic legislation might be necessary in order to implement the provision although other countries might construe the language as being self-executing with no enabling legislation required. In any event, it was generally agreed that, if that provision were included in a bilateral treaty, each contracting party would implicitly undertake to enact enabling legislation, if such legislation was necessary. It was also generally agreed that collection assistance provisions should be the subject of a separate article in order that countries reluctant to accept such provisions might nevertheless agree upon the standards of an article on exchange of information.

It was pointed out that exchange of information should go hand-in-hand with the endeavour to avoid double taxation, e.g., where there had been no wilful misrepresentation of income and no attempt to distract income from taxation in the countries concerned. That would be necessary especially in cases where failure to comply with arm's length standards was the effect of difficulties in bona fide international operations rather than of schemes to avoid tax burdens.

The Group felt that emphasis should be placed on the exchange of information article as an important tool for combating tax evasion. It stressed that the approach (described in the Sixth Report) of placing responsibility on the competent authorities to develop appropriate methods and techniques concerning exchange of information provided a very large degree of flexibility. That flexibility was desirable in order to achieve useful exchanges of information that were consistent with the varying problems faced by different treaty partners.

The Group also called attention to the special matter of tax havens. It indicated that when an entity situated in a tax-haven country was interposed between related entities located in the treaty countries, the possibility of evasion through non-arm's length allocations was greatly increased. Therefore in such a situation, the tax authorities of the treaty countries should be alert to use the exchange of information article to inform themselves on the interrelationships of the dealings between the related entities in the treaty countries and the entity situated in the tax-haven country.

As a protection against improper manipulation of treaty benefits the Group felt that in bilateral negotiations consideration should be given to the inclusion of a separate article along the following lines:

"Each of the Contracting States shall endeavour to collect on behalf of the other Contracting State such taxes imposed by that other Contracting State to the extent necessary to ensure that any exemption or reduced rate of tax granted under this Convention by that other Contracting State shall not be enjoyed by persons not entitled to such benefits."
The commentary on such an article should state that the implementation of the article would require, at least in some countries, internal legislation providing authority for the requisite action. Hence, countries desiring to include such an article should give consideration to this aspect of the matter and discuss the relationship of the article to the internal laws of the countries concerned.
Chapter VII
THE QUESTION OF THE POSSIBLE CONCLUSION OF A MULTILATERAL AGREEMENT ON THE EXCHANGE OF INFORMATION CONCERNING DIRECT TAXATION

In considering this item, the Group of Experts had before it a working paper on the subject (ST/SG/AC.8/L.20). 1/

The paper pointed out that the expansion of international trade and the increase in the flow of capital between one country and another, aided by the technical developments in international communications, had led to the proliferation of transnational corporations and to an ever-growing sophistication and complexity in the forms taken by international business transactions, resulting in increasing tax avoidance and evasion. That situation might, many feared, have reached a point where it might negate completely the effects of the conventions for the avoidance of double taxation as a means of expanding the economies of the developing countries; it raised the question whether steps should be taken outside and in addition to the existing framework of such conventions.

The paper recalled that the Group of Experts had devoted much time to discussing the exchange of information and had expanded the scope of article 26 of the OECD Model Convention. It also pointed out that the Group had always been aware of the inherent restrictions in that article, of the many conditions it contained and of the objective limitations to its effectiveness which arose from the differences in the national legislations of the various countries and in the legal powers conferred on their competent tax authorities in connexion with the provision of information of a particular nature. While it had concentrated on finding solutions on the basis of bilateral treaties, the Group had, in addition, recommended that consideration should also be given as to whether there was a need to draw up a multilateral agreement regarding the exchange of information.

After stressing the limitations of article 26 of the OECD Model Convention, even as recently amended, the paper observed that in order to serve the exchange of information that would be required to combat tax evasion effectively, new measures should be taken outside the existing framework of that article; it pointed out that the quickest and most effective way to do that was by means of a multilateral agreement dealing specifically with the exchange of information and mutual assistance in tax administration.

The paper went on to list the following possible positions which a multilateral agreement of that nature might contain if it were effectively to serve the purpose for which it was intended:

(a) The acceptance by the acceding parties of a clearly defined obligation to supply all the information obtainable under their national laws and administrative procedures, including information they would not be obliged to give under the bilateral conventions;

1/ Contributed by S. Gafny, former Director of State Revenue of Israel, member of the Group of Experts.
(b) The acceptance by all acceding countries of a clear obligation to take all necessary measures to disclose and to impose penalties for tax evasion and to ensure the collection of the full sum of the tax fraudulently evaded;

(c) The setting up of a permanent body along the lines of the Customs Co-operation Council for the purpose of implementing the provisions of the multilateral agreement on a continuing basis; such a body would carry out the following functions:

(i) The formulation of clear procedures for the exchange of information, whether as a matter of routine, at specific request or on a discretionary basis;

(ii) The possible setting up of a central information centre for the collection of information and its distribution to the various competent authorities, in accordance with the procedures formulated for this purpose;

(iii) The creation of machinery for mutual consultation between tax administrators concerned with the exchange of information, so as to promote the exchange of technical know-how, to improve administrative procedures and to develop more effective collection techniques;

(iv) The holding of periodic meetings, on a continuing basis, between representatives of the acceding countries, which could in the course of time develop into a permanent international forum in the field of direct taxation;

(v) The development of new methods and procedures for expediting the exchange of information, including direct visits by tax administrators, the setting up of joint teams for the investigation of a particular taxpayer or a specific economic activity and the encouragement of joint administrative action;

(d) The inclusion of specific provisions for the purpose of overcoming domestic legal obstacles to the effective exchange of information, with particular regard to mutual consultation and the definition of the purposes for which information should be exchanged.

During the ensuing discussion, a member from a developing country observed that the Group would readily agree that tax evasion had to be fought at the international level and that exchange of information was an effective tool for that purpose. The only questions were, therefore, (a) whether it was timely to move at the present time towards the organization of an international framework for that purpose; and (b) how it should be done. He regarded the proposals in the paper as merely an invitation to initiate action towards such an end. The increasing seriousness of tax evasion and avoidance by transnational corporations could not, he thought, be properly tackled in bilateral conventions only. The mere psychological effect of a multilateral framework would in itself have an important impact. Difficulties should, of course, be expected, but difficulties alone were not a justification for lack of action.

Various views were expressed with regard to the feasibility and timeliness of a multilateral agreement on the exchange of information. One member expressed a reservation concerning the institutional framework and recommended that if such an
international body were to be set up it should be under the umbrella of a recognized intergovernmental organization such as the United Nations. Another member questioned the need for a multilateral convention when comparatively few steps had yet been taken to ensure the full implementation of the provisions on exchange of information included in bilateral agreements. Another member indicated that while a multilateral agreement was not to be regarded as an effective tool in the near future it should be considered as a long-range goal, and that in the meantime it was advisable to promote co-operation on a regional basis, since several examples were in evidence— for instance the Nordic Group of European countries and the European Economic Community.

While the idea of working out a multilateral agreement on the exchange of information was considered by most members to be premature, there was a general consensus on the usefulness of a forum for sharing technical experiences in the field of tax administration. It was recognized that the establishment of such a forum would not require a formal multilateral agreement. Therefore, the United Nations Secretariat, in close co-operation with competent intergovernmental organizations and tax administrations in both developed and developing countries, should consider the possibility of undertaking preparatory work for such a project.
Chapter VIII
THE QUESTION OF THE POSSIBLE CONCLUSION OF AN INTERNATIONAL TAX AGREEMENT

It was recalled that, pursuant to Economic and Social Council resolution 1721 (LIII), the Secretary-General had appointed a "group of eminent persons ... to study the role of multinational corporations and their impact on the process of development, especially that of the developing countries, and also their implications for international relations, to formulate conclusions which may possibly be used by Governments in making their sovereign decisions regarding national policy in this respect and to submit recommendations for appropriate international action". The 22 May 1974 report of the Group of Eminent Persons to the Secretary-General contained the following passage:

"Concern was ... expressed in our Group that ... a network of bilateral treaties would entail a large number of treaties which might take a very long time to negotiate and implement. Moreover, they might differ, for instance, as to the amount of withholding tax on the remittance of earnings. Some of the present distortions in the activities of the multinational corporations, therefore, would not be removed. If, through the work of the Group of Experts on Tax Treaties, the provisions of these treaties could be standardized, with only a small number of clauses to be negotiated in particular cases, they would in fact amount to an international agreement on taxation, which we consider to be the final objective." 1/

The Group of Eminent Persons had then recommended, inter alia, "that the bilateral treaties should be as uniform as possible so as to prepare the way for an international tax agreement".

The Group of Experts reviewed briefly the history of efforts directed towards the possible conclusion of an international tax agreement. It was observed that the idea of an international tax agreement was not new. In fact, the Committee on Fiscal Affairs of the Organisation for Economic Co-operation and Development had considered whether the elaboration and conclusion of a multilateral double taxation convention would be feasible. Both in 1963 and in 1976 the Committee on Fiscal Affairs had come to the conclusion that in the current situation it would meet with great difficulties. The Committee had, however, concluded that it might be possible for certain groups of member countries to study the possibility of concluding such a convention among themselves on the basis of the OECD Model Convention, subject to certain adaptations they might consider necessary to suit particular purposes.

In that connexion, the Group was informed that the preparatory work for the possible conclusion of a multilateral tax convention was already at an advanced stage within the Nordic Group of European countries, where a draft agreement had

1/ The Impact of Multinational Corporations on Development and on International Relations (United Nations publication, Sales No. E.74.II.A.5), chap. XI.
been completed. While the OECD Model Convention had constituted the basis for the draft multilateral convention, due account had been taken of particular bilateral problems.

A draft multilateral agreement had also been prepared by the European Free Trade Association; however, although that draft had been deemed technically satisfactory, strong reservations had been expressed about its merits. Problems that could be solved on a bilateral basis could raise great difficulties at the multinational level. It might happen for example that a country which, in considering a specific issue, would readily agree to a series of different provisions in its bilateral dealings, could find none of those provisions acceptable in its dealings on a collective basis.

Mention was also made of the work on the preparation of a preliminary draft double taxation convention on copyright royalties and a preliminary draft protocol annexed to the double taxation convention on copyright royalties being carried on by the Committee of Governmental Experts on the Double Taxation of Copyright Royalties Remitted from One Country to Another convened by the United Nations Educational, Scientific and Cultural Organization.

Members from developed countries stressed that the disadvantages of an international agreement as opposed to a broad system of bilateral tax agreements probably outweighed the benefits to be derived from such an agreement. An especially troublesome point with an international tax agreement was that many matters - such as withholding tax rates and methods of relieving double taxation - would still have to be agreed to bilaterally. Moreover, even if uniformity could be obtained on those matters the goal of an international agreement might well involve the need for uniformity in domestic tax laws such as corporate tax rates and systems.

There was a general consensus within the Group that the idea of an international agreement should be considered as premature and too ambitious for the foreseeable future. It was pointed out that it should be recognized that the absence of a multilateral agreement should not be taken to mean the existence of a "disorderly world" in the field of international taxation. The OECD Model Convention and the guidelines formulated by the Group of Experts as well as the regional initiatives aimed at the conclusion of regional conventions had shown that some important tools already existed or were being worked out for the purpose of avoiding double taxation and removing or at least restricting some distortions created by the activities of transnational corporations.

The Group therefore took the view that a multilateral tax agreement would not seem feasible during the forthcoming decade but, recognizing the seriousness and urgency of many of the issues singled out by the Group of Eminent Persons, it agreed that it was imperative that those issues be dealt with through an adequate network of bilateral tax treaties. It would therefore seem appropriate for the competent bodies of the United Nations to urge member countries to embark as soon as possible on a policy of entering into such treaties. In that connexion the Group expressed its readiness to consider a draft model convention between developed and developing countries that the United Nations Secretariat might wish to prepare as a follow-up to the work of the Group during its first seven meetings.
Chapter IX

THE QUESTION OF THE POSSIBLE CONCLUSION OF AN INTERNATIONAL AGREEMENT ON TRANSFER PRICING

The Group of Experts was reminded that the 1974 Group of Eminent Persons Appointed to Study the Impact of Multinational Corporations on Development and on International Relations had in its May 1974 report to the Secretary-General expressed the following views:

"We note with satisfaction that transfer pricing has been engaging the attention of the United Nations Group of Experts on Tax Treaties, the International Fiscal Association, the Organisation for Economic Co-operation and Development and the Commission of the European Communities. We trust that, as a result of their efforts, it will be possible for the international community to agree upon a code which home and host countries alike will find practicable and advantageous to enforce.

"Meanwhile some action is clearly necessary. Some countries have begun to regulate transfer prices, chiefly in order to prevent tax evasion. Such legislation is particularly advanced in the United States Internal Revenue Code 482; in other countries, tax authorities are also developing their inquiries and the formulation of rules. The general principle is to refer to 'arm's length' prices, that is, prices as they are or would be charged by an independent seller to an independent buyer. In case the nature of the product, the components of a machine, for instance, or new drugs, is such that there is no comparable independent transaction, the usual principle applied by tax authorities is a reference to the general practice of the company concerned." 1/

The Group of Eminent Persons recommended, inter alia, that home and host countries should consider the feasibility of an international agreement on the rules concerning transfer pricing for purposes of taxation.

The view was expressed that it should be stressed that the Group of Experts had unanimously recognized the validity of the arm's length principle and that Governments should apply arm's length pricing wherever appropriate. The Group, after recognizing the need for a further discussion in depth on the subject, indicated that for the time being it did not seem feasible to initiate preparatory work for the conclusion of a multilateral agreement that could cover all the controversial issues involved in transfer pricing. The Group agreed that at the present time the matter of transfer pricing arrangements should be settled, in the light of the guidelines it had already formulated and the further studies of the subject that it would pursue, in the course of the negotiations on bilateral tax treaties.

1/ The Impact of the Multinational Corporations on Development and on International Relations (United Nations publication, Sales No. E.74.II.A.5), chap. X.
Chapter X

PRACTICAL SUGGESTIONS CONCERNING THE DISSEMINATION AND APPLICATION OF THE GUIDELINES FORMULATED BY THE GROUP OF EXPERTS

The Group took the view that its very existence proved the interest of the Member States in double taxation treaties. Two practical questions should be raised with respect to the dissemination of the Group's findings and recommendations: (a) how to reach tax policy makers and tax administrators in developing countries and (b) how to help them, at their request, to benefit to the largest extent from the Group's findings and suggestions.

It was pointed out that the discussions during the Sixth Meeting had laid great emphasis on the need to disseminate the guidelines formulated by the Group. The Group noted that, pending the preparation of the draft model convention referred to in chapter VIII of the present report, the United Nations Secretariat would need an interim document for dissemination purposes. With regard to the draft model convention, the Group urged the United Nations Secretariat to take the necessary steps in order to submit such a draft to its Eighth Meeting. With regard to the interim document, which the United Nations intended to use for the purpose of technical co-operation, such a document would consolidate the guidelines already published and those formulated at the Sixth and Seventh Meetings. In view of the urgency of disseminating those guidelines and thereby helping to promote the conclusion of bilateral tax treaties, the Group recommended that the draft consolidated document be submitted to it for discussion as soon as possible, preferably at a special one-week meeting which would take place, for example, in the second half of 1978. If it did not prove feasible to convene the special one-week meeting of the entire Group, the United Nations Secretariat might wish to consider convening a one-week meeting of the Drafting Committee constituted for the Seventh Meeting, which would review and approve the draft consolidated document on behalf of the Group. Other members of the Group and the observers would be invited to attend the Meeting of the Drafting Committee at their own expense. Prior to the Special Meeting of the Group or to the Meeting of the Drafting Committee, the United Nations Secretariat would circulate the draft consolidated document to all members of the Group for their comments. Once adopted, by or on behalf of the Group, the consolidated document would be sent to all Member States through the usual channels and would also be used as a working paper for workshops, seminars and other similar gatherings.

In that connexion, a member from a developing country observed that, in some cases, documents related to the Group's work never reached the authorities directly involved in tax policy-making, and that it would increase those authorities' awareness of the importance of double taxation treaties if the United Nations Secretariat were able to correspond directly with them. He also suggested that intergovernmental organizations such as the International Monetary Fund, the World Bank and the regional development banks be associated with the dissemination of those documents.

It was observed that some developing countries might have to familiarize
their tax officials with the problems involved in negotiating treaties for the avoidance of double taxation and that they might have to consider the possible revision of some administrative procedures in order to ensure the smooth implementation of such treaties.

The hope was voiced that if an individual country were to express a desire for technical guidance in that field, the United Nations would consider the possibility of providing assistance within the framework of its technical assistance programme.

The hope was also expressed that the United Nations, in close co-operation with the five regional commissions, would work out a programme of co-operation on a regional or interregional basis which would include the convening of workshops or the organization of training programmes to which Member States might consider contributing.
Chapter XI
OTHER MATTERS

Discussion of recent work done by other organizations concerning treaties for the avoidance of double taxation

The Group was briefed about the changes in the OECD Model Convention which were published in 1977.

Many members from developing countries indicated that they desired time to study those changes before considering any appropriate revision of the guidelines already formulated by the Group.

Consideration of articles on personal scope, taxes covered, general definitions, resident and diplomatic agents and consular offices

The Group considered articles 1, 2, 3, 4 and 27 of the OECD Model Convention which read as follows:

"Article 1
PERSONAL SCOPE

This Convention shall apply to persons who are residents of one or both of the Contracting States.

"Article 2
TAXES COVERED

1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.

3. The existing taxes to which the Convention shall apply are in particular:

(a) (In State A): .................................................................

(b) (In State B): .................................................................
1. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. At the end of each year, the competent authorities of the Contracting States shall notify each other of changes which have been made in their respective taxation laws.

"Article 3

GENERAL DEFINITIONS

1. For the purposes of this Convention, unless the context otherwise requires:

   (a) The term 'person' includes an individual, a company and any other body of persons;

   (b) The term 'company' means any body corporate or any entity which is treated as a body corporate for tax purposes;

   (c) The terms 'enterprise of a Contracting State' and 'enterprise of the other Contracting State' mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;

   (d) The term 'international traffic' means any transport by a ship or aircraft operated by an enterprise which has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;

   (e) The term 'competent authority' means:

       (i) (in State A): .....................................................

       (ii) (in State B): .....................................................

2. As regards the application of the Convention by a Contracting State any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the law of that State concerning the taxes to which the Convention applies.

"Article 4

RESIDENT

1. For the purposes of this Convention, the term 'resident of a Contracting State' means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature. But this term does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.
2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:

   (a) He shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (centre of vital interests);

   (b) If the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;

   (c) If he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;

   (d) If he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the State in which its place of effective management is situated.

"Article 27

DIPLOMATIC AGENTS AND CONSULAR OFFICERS

Nothing in this Convention shall affect the fiscal privileges of diplomatic agents or consular officers under the general rules of international law or under the provisions of special agreements."

As to the first three articles and article 27, the consensus of the Group was that they were non-controversial and hence could be accepted without alteration.

With regard to article 4, a question was raised as to the meaning of the second sentence of paragraph 1 relating to the definition of resident. It was pointed out that such a sentence was added in order to deal with the special situation of diplomats, who might be considered to be residents under the domestic law of a Contracting State but were only taxable on items of income from sources in such States. It was noted, however, that the sentence could have a considerably broader impact, even to the extent of denying the benefits of a treaty to the residents of a Contracting State which taxed solely income from domestic sources.

The consensus of the Group was therefore that article 4 of the OECD Model Convention was acceptable provided that the second sentence of paragraph 1 of that article was deleted. The Group also agreed that the commentary to article 4 should include the following:

"The OECD Model includes a sentence at the end of paragraph 1 of
article 4 which states: 'But this term [resident] does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein'. The Group was of the view that although some countries might wish to include that sentence in bilateral agreements, attention should be called to the fact that in some bilateral cases the sentence would be inappropriate for inclusion in a treaty. If one of the Contracting States taxed solely income from domestic sources and did not tax income from foreign sources, the inclusion of that sentence would result in all residents of that country being characterized as non-residents for purposes of the tax treaty and as a result being deprived of the benefits of the treaty. The Group therefore did not deem it appropriate to include such a sentence in the guidelines.'
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